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## INTRODUCTION

The development of the state budget is one of the most important responsibilities of state government. The state budget has wide-ranging and far-reaching impacts on the well-being of the citizens of the Commonwealth. It is the vehicle through which we as a citizenry make investments together for the benefit of all of us – investments for the “commonwealth”. It reflects our collective judgment about the state’s role in our society, the fellow citizens we want to help, the investments in our future we want to make and the cost we are each willing to bear to pay for the things that we as a citizenry need and want to do together.

There are a number of factors that have made it challenging to develop a fiscally responsible and balanced budget for fiscal year 2009, which begins on July 1, 2008 and ends on June 30, 2009. A significant structural deficit in the fiscal year 2008 budget will persist into fiscal year 2009. In addition, growth in expenses to simply maintain the same level of state services exceeds the estimated growth in state tax revenue for fiscal year 2009. This structural shortfall between revenues and expenses to maintain existing levels of services is the starting point for building a state budget for fiscal year 2009, even before taking into account the many new, worthy programs or investments the Governor, legislators, stakeholders and other citizens would like to fund in the budget.

In order to provide the level of state services and investments the citizens of the Commonwealth expect, need and deserve, it is critical that we use the taxpayers’ money as efficiently and effectively as possible. This means that the state must do everything possible to control costs, particularly in areas like health care which already consumes almost half of the state budget and in which costs are growing at a rate much higher than the growth in state tax revenues. This also means that the state must make investments to grow its way out of its persistent structural deficit and onto a course of financial sustainability. Targeted investments to support long-term economic growth will yield new state tax revenues from new businesses, new jobs and higher levels of economic activity. As discussed in greater detail in the Governor’s message, the Secretary of Administration and Finance’s message and the budget narrative above, the Governor has undertaken a number of efforts to realize efficiencies and to control costs, and he has made and proposed a number of targeted investments to spur economic growth.

The discussion below provides a description of the relevant issues faced by the Administration and the process that was used to develop the Governor’s proposal for the fiscal year 2009 state budget.

## Massachusetts Government Structure

The government of the Commonwealth is divided into three branches: the Executive, the bicameral Legislature and the Judiciary.

### Executive Branch

*Governor* – The Governor is the chief executive officer of the Commonwealth. Other elected members of the executive branch are the Lieutenant Governor (elected with the Governor), the Treasurer and Receiver-General (State Treasurer), the Secretary of the Commonwealth (State Secretary), the Attorney General and the State Auditor. All are elected to four-year terms. The terms of the current office holders began in January, 2007.

The Executive Council, also referred to as the “Governor’s Council,” consists of eight members who are elected to two-year terms in even-numbered years. The Executive Council is responsible for the confirmation of certain gubernatorial appointments, particularly judges, and must approve all warrants (other than for debt service) prepared by the Comptroller for payment by the State Treasurer.

Also within the Executive Branch are certain independent offices, each of which performs a defined function, such as the Office of the Comptroller, the Office of the Inspector General, the State Ethics Commission and the Office of Campaign and Political Finance.

*Governor’s Cabinet* – The Governor’s Cabinet, which assists the Governor in administration and policy making, is comprised of the secretaries who head the eight Executive Offices, which are the Executive Office for

Administration and Finance, the Executive Office of Health and Human Services, the Executive Office of Transportation and Public Works, the Executive Office of Public Safety and Security, the Executive Office of Housing and Economic Development, the Executive Office of Labor and Workforce Development, the Executive Office of Education and the Executive Office of Energy and Environmental Affairs. Finally, the Governor chairs an informal Development Cabinet to coordinate business development in the Commonwealth; it includes the Secretaries of Administration and Finance, Housing and Economic Development, Transportation and Public Works, Energy and Environmental Affairs and Labor and Workforce Development. Cabinet secretaries and executive department chiefs serve at the pleasure of the Governor. Most other agencies are grouped under one of the eight Executive Offices for administrative purposes.

The Cabinet structure described above results from a constitutionally provided reorganization plan proposed by the Governor and approved unanimously by the legislature, which took effect on April 9, 2007 and the Governor's recently proposed legislation, reflected in these Budget Recommendations, to organize the education agencies under a new Secretary of Education . (See Commonwealth Organization Chart)

The Governor's chief fiscal officer is the Secretary of Administration and Finance. The activities of the Executive Office for Administration and Finance fall within five broad categories: (i) administrative and fiscal supervision, including supervision of the implementation of the Commonwealth's budget and monitoring of all agency expenditures during the fiscal year; (ii) enforcement of the Commonwealth's tax laws and collection of tax revenues through the Department of Revenue for remittance to the State Treasurer; (iii) human resource management, including administration of the state personnel system, civil service system and employee benefit programs and negotiation of collective bargaining agreements with certain of the Commonwealth's public employee unions; (iv) capital facilities management, including coordinating and overseeing the construction, management and leasing of all state facilities; and (v) administration of general services, including information technology services.

*State Treasurer* – The State Treasurer has four primary statutory responsibilities: (i) the collection of all state revenues (other than small amounts of funds held by certain agencies); (ii) the management of both short-term and long-term investments of Commonwealth funds (other than the state employee and teacher pension funds), including all cash receipts; (iii) the disbursement of Commonwealth monies and oversight of reconciliation of the state's accounts; and (iv) the issuance of almost all debt obligations of the Commonwealth, including notes, commercial paper and long-term bonds.

In addition to these responsibilities, the State Treasurer serves as Chairperson of the Massachusetts Lottery Commission, the State Board of Retirement, the Pension Reserves Investment Management Board, the Massachusetts Water Pollution Abatement Trust and the Massachusetts School Building Authority. The State Treasurer also serves as a member of numerous other state boards and commissions, including the Municipal Finance Oversight Board.

*State Auditor* – The State Auditor is charged with improving the efficiency of state government by auditing the administration and expenditure of public funds and reporting the findings to the public. The State Auditor reviews the activities and operations of approximately 750 state entities and contract compliance of private vendors doing business with the Commonwealth.

*Attorney General* – The Attorney General represents the Commonwealth in all legal proceedings in both the state and federal courts, including defending the Commonwealth in actions in which a state law or executive action is challenged. The Attorney General also brings actions to enforce environmental and consumer protection statutes, among others, and represents the Commonwealth in public utility and automobile and health insurance rate setting procedures. The Attorney General works in conjunction with the general counsel of the various state agencies and executive departments to coordinate and monitor all pending litigation.

*State Comptroller* – Accounting policies and practices, publication of official financial reports and oversight of fiscal management functions are the responsibility of the Comptroller. The Comptroller also administers the Commonwealth's annual state single audit and manages the state accounting system. The Comptroller is appointed by the Governor for a term coterminous with the Governor's and may be removed by the Governor only for cause. The annual financial reports of the Commonwealth, single audit reports and any rules and regulations

promulgated by the Comptroller must be reviewed by an advisory board. This board is chaired by the Secretary of Administration and Finance and includes the State Treasurer, the Attorney General, the State Auditor, the Chief Administrative Justice of the Trial Court and two persons with relevant experience appointed by the Governor for three-year terms. The Commonwealth's audited annual reports include audited financial statements on both the statutory basis of accounting (the Statutory Basis Financial Report, or SBFR) and the GAAP basis (the Comprehensive Annual Financial Report, or CAFR).

*State Secretary* – The Secretary of the Commonwealth is responsible for collection and storage of public records and archives, securities regulation, state elections, administration of state lobbying laws and custody of the seal of the Commonwealth.

## **Legislative Branch**

The Legislature (formally called the General Court) is the bicameral legislative body of the Commonwealth, consisting of a Senate of 40 members and a House of Representatives of 160 members. Members of both the Senate and the House are elected to two-year terms in even-numbered years. The Legislature meets every year. The joint rules of the House and Senate require all formal business to be concluded by the end of July in even-numbered years and by the third Wednesday in November in odd-numbered years.

The House of Representatives must originate any bill that imposes a tax. Once a tax bill is originated by the House and forwarded to the Senate for consideration, the Senate may amend it. All bills are presented to the Governor for approval or veto. The Legislature may override the Governor's veto of any bill by a two-thirds vote of each house. The Governor also has the power to return a bill to the chamber of the Legislature in which it was originated with a recommendation that certain amendments be made; such a bill is then before the Legislature and is subject to amendment or re-enactment, at which point the Governor has no further right to return the bill a second time with a recommendation to amend but may still veto the bill.

## **Judicial Branch**

The judicial branch of state government is composed of the Supreme Judicial Court, the Appeals Court and the Trial Court. The Supreme Judicial Court has original jurisdiction over certain cases and hears appeals from both the Appeals Court, which is an intermediate appellate court, and in some cases, directly from the Trial Court. The Supreme Judicial Court is authorized to render advisory opinions on certain questions of law to the Governor, the Legislature and the Governor's Council. Judges of the Supreme Judicial Court, the Appeals Court and the Trial Court are appointed by the Governor, with the advice and consent of the Governor's Council, to serve until the mandatory retirement age of 70 years.

## **Independent Authorities and Agencies**

The Legislature has established a number of independent authorities and agencies within the Commonwealth, the budgets of which are not included in the Commonwealth's annual budget.

## **Local Government**

All territory in the Commonwealth is in one of the 351 incorporated cities and towns that exercise the functions of local government, which include public safety, fire protection and public construction. Cities and towns or regional school districts established by them also provide elementary and secondary education. Cities are governed by several variations of the mayor-and-council or manager-and-council form. Most towns place executive power in a board of three or five selectmen elected to one- or three-year terms and retain legislative powers in the voters themselves, who assemble in periodic open or representative town meetings. Various local and regional districts exist for schools, water and wastewater administration and certain other governmental functions.

Municipal revenues consist of taxes on real and personal property, distributions from the Commonwealth under a variety of programs and formulas, local receipts (including motor vehicle excise taxes, local option taxes, fines,

licenses and permits, charges for utility and other services and investment income) and appropriations from other available funds (including general and dedicated reserve funds). Because property tax levies are limited by Proposition 2½, an initiative petition approved by the voters in 1980, local governments have become increasingly reliant on distribution of revenues from the Commonwealth to support local programs and services, although the amount of aid received varies significantly among municipalities.

The cities and towns of the Commonwealth are also organized into 14 counties, but county government has been abolished in seven of those counties. The county governments that remain are responsible principally for the operation of courthouses and registries of deeds. Where county government has been abolished, the functions, duties and responsibilities of the government have been transferred to the Commonwealth, including all employees, assets, valid liabilities and debts. The Governor proposes to move the remaining County Sheriffs to the state in this budget. (See Budget Narrative)

## **Overview of the Operating Budget Process**

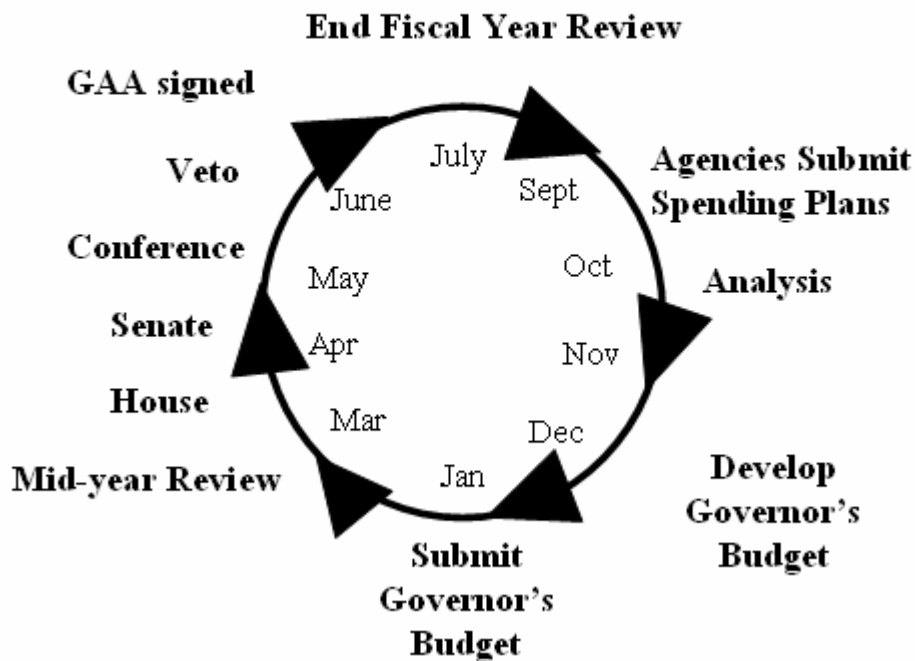
Generally, funds for the Commonwealth's programs and services must be appropriated by the Legislature. The process of preparing a budget begins with the Executive branch early in the fiscal year preceding the fiscal year for which the budget will take effect. The Massachusetts Constitution requires that the Governor recommend to the Legislature a budget which contains a statement of all proposed expenditures of the Commonwealth for the upcoming fiscal year, including those already authorized by law, and of all taxes, revenues, loans and other means by which such expenditures are to be defrayed. State finance law (Chapter 29 of the M.G.L.) requires the Legislature and the Governor to approve a balanced budget for each fiscal year, and the Governor may approve no supplementary appropriation bills that would result in an unbalanced budget.

After working with agencies to analyze spending plans submitted in the fall of each year and under the direction of the Governor's Office, the Executive Office of Administration and Finance (A&F) prepares the Governor's budget recommendations, otherwise known as House 1 (in odd years) and House 2 (in even years). For this year's budget, each Secretariat held hearings across the state to solicit input on programs and services from the general public. This information was considered by agencies in the development of their spending plans. Under the state Constitution the Governor is required to file his budget by the third Wednesday in January – the fiscal year 2009 budget will be filed on January 23<sup>rd</sup>. The budget recommendations are filed with the House of Representatives.

The Governor's budget is referred for consideration to the House Ways and Means Committee, which in turn proposes a budget to the full House of Representatives. Once approved by the House, the budget is referred to the Senate Ways and Means Committee, which in turn proposes a budget to be considered by the full Senate. In recent years, the legislative budget review process has included joint hearings by the Ways and Means Committees of the Senate and the House. After Senate action, a legislative conference committee develops a joint budget recommendation for consideration by both houses of the Legislature, which upon adoption is sent to the Governor.

Before signing the appropriations act, the Governor may veto the budget in whole or disapprove or reduce specific line items (line-item veto). The Legislature may override the Governor's veto or specific line-item vetoes by a two-thirds vote of both the House and Senate. The annual budget legislation, as finally enacted, is known as the general appropriations act (GAA).

## Commonwealth's Budget Calendar



### General Financial and Budget Policies

This budget document provides the Governor's budget recommendations for the fiscal year beginning July 1, 2008 and ending June 30, 2009. The budget is balanced, with the projected revenues from taxes and other sources being sufficient to cover recommended expenses. The Commonwealth uses a statutory basis of accounting to define balance where actual revenues received within the fiscal year must meet or exceed actual expenditures.

The state's finance laws are contained in Chapter 29 of the Massachusetts General Laws. They require that the Governor file a balanced budget, that the House and Senate each produce a balanced budget, and that the final GAA be in balance. Any supplemental budget bill cannot impair the overall fiscal balance. One method of achieving balance may be through accessing the Commonwealth's Stabilization Fund, also known as the Rainy Day Fund.

Prior to the Governor's submission of the budget, the Secretary for Administration and Finance, and the House and Senate Committees on Ways and Means are required to agree on a "consensus tax revenue forecast" from which to build their spending projections. The consensus revenue process for fiscal year 2009 is laid out in more detail further on in this section.

Generally, expenditures may not exceed the level of spending authorized for an appropriation account. However, the Commonwealth is statutorily required to pay debt service, regardless of whether such amounts are appropriated.

State finance law requires the Commonwealth to monitor revenues and expenditures during a fiscal year. For example, the Secretary of Administration and Finance is required to provide quarterly revenue estimates to the Governor and the Legislature, and the Comptroller publishes a quarterly report of planned and actual revenues.

Department heads are required to notify the Secretary of Administration and Finance and the House and Senate Committees on Ways and Means of any anticipated decrease in estimated revenues for their departments from the federal government or other sources. Those same parties are also notified if a department projects that any appropriation will be insufficient to meet all expenditures required in the fiscal year by any law, rule, regulation or order not subject to administrative control.

The budget may be amended through the filing of a supplement budget request, which is submitted by the Governor to the House of Representatives. Supplemental budgets follow the same process as the overall budget, going first to the House Committee on Ways and Means, then to the House for approval, followed by the Senate Committee on Ways and Means and the full Senate. If there are differences between the House and Senate versions, a conference committee produces a final supplemental bill that is then enacted by both chambers and then sent to the Governor for approval. The Governor has the same line-item veto powers as with the general budget, where he is able to veto specific amounts from particular line items, entire line items, or entire provisions of language.

The Secretary of Administration and Finance is responsible for monitoring revenue collections throughout the year, and updating them as needed. If a revenue shortfall is identified, the Governor is required by section 9C of Chapter 29 to reduce agency appropriations or recommend a transfer from the Stabilization Fund. If additional revenues are available, the Governor may recommend a supplemental budget. At the end of the fiscal year, the Comptroller determines the statutory balance of the budgeted funds and transfers any excess funds to the Stabilization Fund.

## Overview of Budget Funds

Government Fund Types account for the general governmental activities of the Commonwealth and are organized as follows:

*Budgeted Funds* – are the primary operating funds of the Commonwealth. They account for all budgeted governmental transactions. Major budgeted funds include the General, Stabilization and Highway funds, which are identified by the Comptroller as the operating funds of the Commonwealth.

*Non-Budgeted Special Revenue Funds* – are established by law to account for specific revenue sources that have been segregated from the budgeted funds to support specific governmental activities such as federal grants, funds related to the tobacco settlement and the operations of the state lottery.

*Capital Projects Funds* – account for financial resources used to acquire or construct major capital assets and to finance local capital projects. These resources are derived from proceeds of bonds and other obligations, operating transfers authorized by the Legislature and from federal reimbursements.

### **Individual Budgeted Funds**

Statutory balance is defined as *a measure of the fiscal condition which includes current year budgeted revenues and expenditures plus any designated revenues from prior years, stabilization deposit, and funds carried forward. It also includes any use of stabilization or any other non-budgeted reserves.* Although the Commonwealth's overall fund balance is positive, there are several funds that are running in deficit. Because the General Fund, Highway Fund (renamed Transportation Fund), Workforce Training Fund, and the Massachusetts Tourism Fund all contribute to overall balance, the deficits in one fund may be offset by surpluses in other funds. The Governor's budget proposes to change this by requiring the Comptroller to eliminate deficits in funds using surpluses from other funds. This will ensure that each year will begin and end with a zero or positive fund balance. A more general discussion of the funds is below:

*The General Fund* – The General Fund is the Commonwealth's primary Governmental Fund. All governmental activities not specifically directed to another fund are accounted for in the General Fund. As a result, most budgeted expenditures of the Executive secretariats, the Legislature, Constitutional offices, Judiciary, institutions of higher education and independent commissions are paid for from the General Fund. It similarly receives a

significant portion of sales, individual income and corporate taxes, and the full amount of most other governmental taxes.

*Highway Fund (Transportation Fund)* – This fund accounts for highway user taxes including the gas tax and fees. The fund is used to finance highway maintenance and safety services, and provide matching funds for federally sponsored highway projects as required. For fiscal year 2009, the Governor proposes to rename the fund the *Transportation Fund* and further recommends restructuring the fund to ensure that all transportation-related revenues are directed to the new fund, and to make sure that all funding for transportation-related expenses (including debt service on bonds issued for transportation purposes) are paid from this fund. This reform would provide the Commonwealth and the public with a more transparent and true accounting of our transportation revenues and expenses and to the extent to which transportation expenses need to be subsidized by non-transportation-related General Fund receipts.

*Infrastructure Fund* (Sub-fund of the former Highway Fund) – As part of the reform, this fund is being eliminated and all of the revenues and expenditures paid from the fund will be directed to the new Transportation Fund.

The *Workforce Training Fund*, authorized in section 2RR of Chapter 29 of the M.G.L. and administered by the Executive Office of Labor and Workforce Development, provides employers with matching grants of up to \$250,000 or more to help train new and incumbent workers. The Workforce Training Fund is a state fund enacted into law in July 1998 and financed entirely by Massachusetts employers. The Workforce Training Fund in fiscal year 2007 was financed by an employer surcharge of \$8.40 per employee, as part of their overall unemployment insurance contribution. The flat rate Workforce Training Contribution is 0.06% of the taxable wages in calendar year 2008. This payment, which is in addition to the Unemployment Insurance contribution payment, is deposited in the Workforce Training Fund which is used to award grants to companies to provide workforce training and education programs for incumbent workers. Annual state revenues from employer contributions total approximately \$21 million, and state appropriations for competitive training grants are continually rolled forward into future fiscal years to provide for multiple-year grant awards.

The *Massachusetts Tourism Fund*, authorized in section 35J of Chapter 10 of the MGL, is funded with 35 percent of the State's annual revenues received from the hotel occupancy tax authorized in section 3 of Chapter 64G. In fiscal year 2008, Tourism Fund revenues are estimated to total \$44 million. The Fund's use is proscribed in Chapter 10, which includes a formula that assigns various funding levels for tourism promotion programs and activities, including the Massachusetts Office of Travel and Tourism, regional tourism promotion agencies, the Massachusetts Office of International Trade and Investment, and the Cultural Facilities Fund. While funding for the purposes prescribed in the section are being made in this budget, the specific requirements of the fund have been suspended through an outside section for the last several years.

*The Commonwealth Stabilization Fund* – This fund is a reserve to enhance the Commonwealth's fiscal stability. (A later section describes the Stabilization Fund in more detail.)

Administrative Control Funds account for the revenues generated by certain administrative functions of government, for which the Legislature has required that separate funds be established. These funds include:

- *Temporary Holding Fund* – to account for cumulative tax revenues during the fiscal year in excess of permissible tax revenues as defined in Chapter 62F, Section 6A of the General Laws. The fund balance is transferred annually to the Stabilization Fund only to the extent that stabilization funds are used to fund expenditures of the Commonwealth. Overall, any remaining balance is transferred to the General Fund.
- *Intergovernmental Service Fund* – to account for the charges of any state agency for services provided by another state agency, for example, charges levied by the Human Resources Division for a workers' compensation chargeback.
- *Bay State Competitiveness Fund* – to account for funds received as part of the calculation of consolidated net surplus. This fund was created on a one-time basis in the fiscal year 2008 budget. The Governor's proposal is to make the fund permanent and allocate the first \$100 million of surplus funds on an annual basis to the following programs:



- The first \$25 million (of the \$100 million) would be reserved for investments in life sciences. The remaining \$75 million would then be allocated to the following programs:
- Alternative and Clean Energy Fund (\$20 million)
- Affordable Housing Trust Fund (\$15 million)
- Workforce Competitiveness Trust Fund (\$15 million)
- Low-income heating and energy assistance (\$15 million)
- Cultural Facilities Fund (\$7 million)
- Regional Efficiency Assistance Grant Trust Fund (\$3 million).

If the Bay State Fund has less than \$75 million after life sciences investments, the funding would be allocated proportionally among these purposes.

*Inland Fisheries and Game Fund* – to account for revenues from license and permit fees for inland fishing, hunting, trapping, and sporting licenses and revenue producing stamps or the sales of land, rights and properties, gifts, interest, and federal grant reimbursements; used for developing, maintaining and operating the Division of Fisheries and Wildlife.

## FISCAL YEAR 2009 BUDGET

### Revenue Development

#### Tax Revenues

Tax revenues comprise nearly 70% of all revenues (including new revenues proposed in the H.2 recommendations) used to support the Commonwealth's operating budget. Each year the Administration and the House and Senate consult with economists and other groups to gather information and analysis on the condition of the U.S. and Massachusetts economies. They use that information to project state tax revenue for use in the state budget. The following is a general description of the consensus revenue process.

#### ***General Information Regarding Consensus Revenue***

The consensus revenue process is required under M.G.L. c.29, s.5B and states that on or before January 15 the Secretary for Administration and Finance shall meet with the House and Senate Committees on Ways and Means and shall jointly develop a consensus tax revenue forecast for the budget for the next fiscal year, which shall be agreed to by the Secretary and the House and Senate. The law requires that the consensus revenue estimate be placed before the General Court in the form of a joint House and Senate Resolution for full consideration.

On December 13, 2007 the Secretary for Administration and Finance and the House and Senate Committees on Ways and Means held a public hearing in Boston and heard testimony from the Massachusetts Department of Revenue (DOR), the Federal Reserve Bank of Boston, the Massachusetts Taxpayers Foundation and the Beacon Hill Institute. The three branches subsequently agreed upon a fiscal year 2009 tax revenue estimate of \$20.987 billion, consistent with testimony presented at the hearing.

As part of the statutorily required consensus revenue process, the Secretary, House and Senate also agree on the amount of tax revenues that will need to be transferred to support the State's Pension Fund, the School Building Authority and the MBTA (Massachusetts Bay Transportation Authority). For fiscal year 2009, these transfers are estimated to total \$2.935 billion and will be directed to the following funds:

- |                                                      |      |                            |
|------------------------------------------------------|------|----------------------------|
| • School Modernization and Reconstruction Trust Fund | = \$ | 702 million                |
| • MBTA State and Local Contribution Fund             | = \$ | 768 million                |
| • Pension Reserves Investment Trust Fund             | = \$ | <u>1.465 billion</u>       |
|                                                      |      | \$ 2.935 billion total     |
|                                                      |      | \$18.052 billion remaining |

### ***Basis for the Fiscal Year 2009 Consensus Revenue Forecast***

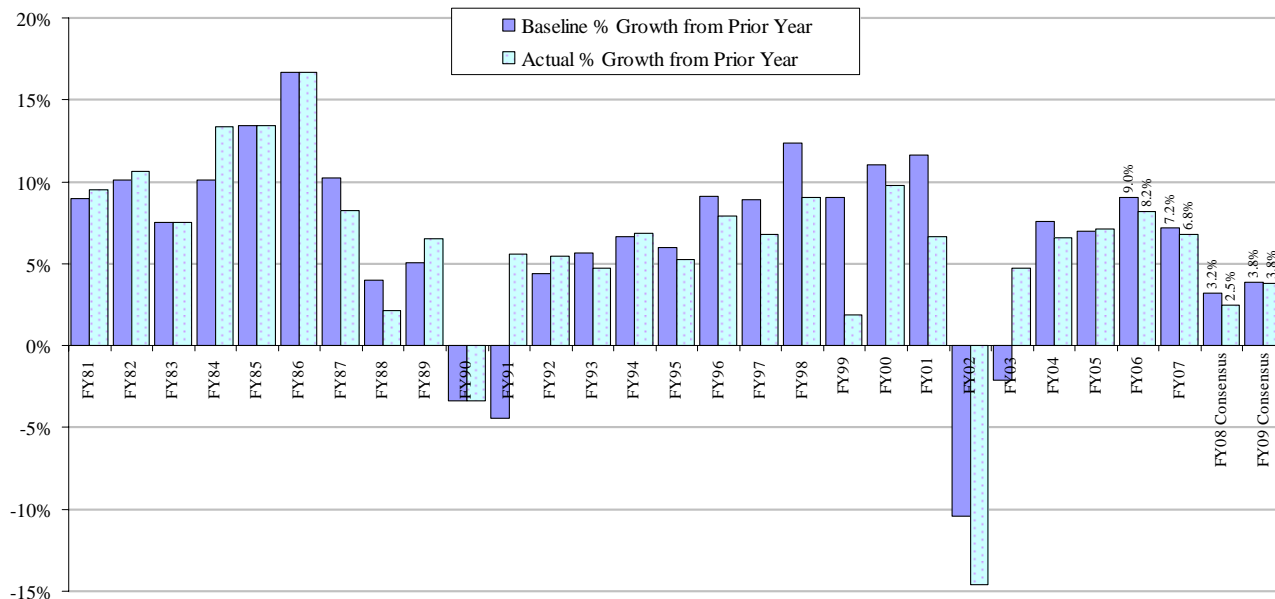
Fiscal year 2008 tax revenues are estimated to be \$20.225 billion, representing growth of 2.5% actual and 3.2% baseline over fiscal year 2007 collections (the baseline calculation adjusts for the impact of tax law and processing changes, so is a better indicator of underlying economic activity). Through December 2007, fiscal year 2008 year-to-date tax revenues were up 4.2% actual and 4.8% baseline, and were \$22 million above the year-to-date benchmark based on the \$20.225 billion estimate.

The fiscal year 2009 consensus tax revenue estimate is \$20.987 billion, representing revenue growth of 3.8% actual and baseline from the fiscal year 2008 estimate of \$20.225 billion. The fiscal year 2009 estimate assumes that the national and state economies will both experience slowdowns over the next 18 months, but that both will avoid a recession. Specifically, the consensus forecast assumes the following:

- The national economy is expected to experience a slowdown during fiscal year 2009, with real Gross Domestic Product (GDP) growth of 2.2%, versus 2.3% GDP growth in fiscal year 2008.
- Massachusetts gross state product is also expected to slow, from a growth rate of 2.2% to 2.4% in fiscal year 2008 to between 1.8% and 2.2% in fiscal year 2009.
- Massachusetts employment is expected to grow 0.6% in fiscal year 2009, compared to 1.0% in fiscal year 2008, and Massachusetts wages and salaries are expected to increase 4.5% in fiscal year 2009, compared to 5.7% in fiscal year 2008.
- Massachusetts personal income is expected to rise 4.6% in fiscal year 2009, compared to 5.7% in fiscal year 2008.
- Massachusetts retail sales are expected to grow by 2.6% in fiscal year 2009, compared to 3.2% in fiscal year 2008.
- After growing by 9.2% in fiscal year 2007, corporate profits at the national level are expected to decline moderately in fiscal year 2008, but then recover in fiscal year 2009. Corporate profits are projected to grow between 1.3% and 3.7% in fiscal year 2009, compared to fiscal year 2008 (there are no forecasts for state corporate profits). This compares with the double-digit growth in the four-year period of fiscal year 2003 to fiscal year 2006.
- Massachusetts capital gains taxes, which grew by about 6.6% in fiscal year 2007, are expected to decline slightly in fiscal year 2008 and then remain flat in fiscal year 2009.

Based on these economic projections, fiscal year 2009 tax collections are projected to grow by \$762 million over fiscal year 2008, with income tax collections growing by 5.8% actual and 6.0% baseline, sales tax growing by 3.3% actual and 2.7% baseline, corporate and business taxes declining by 3.3% actual and 3.2% baseline. There is usually a lag between a decline in corporate profits and when that decline is reflected in tax collections, which explains why corporate tax collections are projected to decline in fiscal year 2009, even though corporate profits are expected to grow from the prior fiscal year.

**Actual & Baseline Annual Tax Revenue Growth, FY1981-FY2009**  
(FY08 and FY09 Estimates are Average of 3 Forecasts)



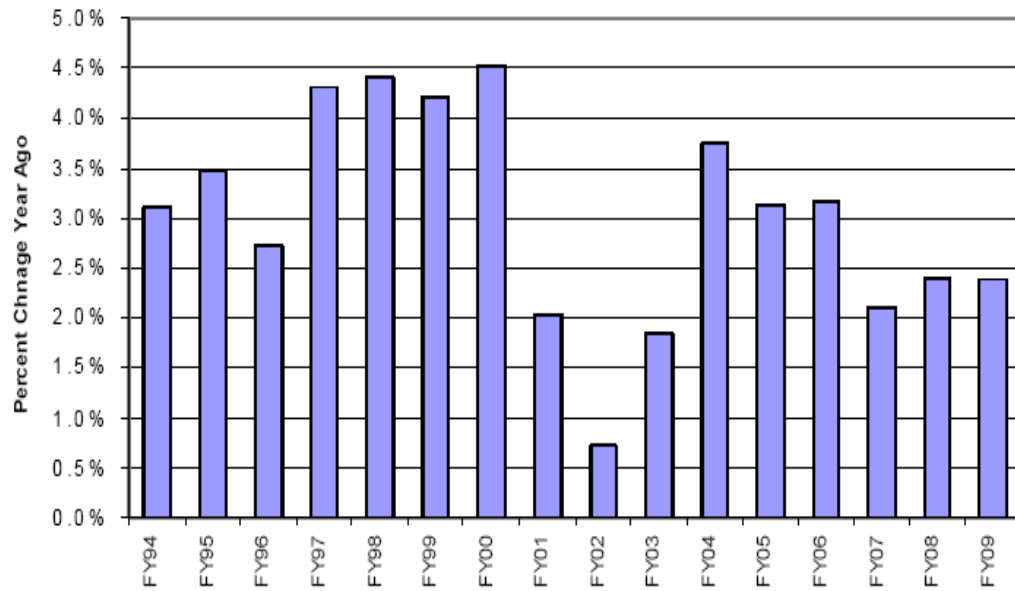
### ***The US Economy***

DOR utilizes national and Massachusetts forecasts from Global Insight, Moody's Economy.com, and the New England Economic Partnership. These report the following:

- The national economy is expected to slow substantially over the next several quarters due to the slump in the housing market, the turmoil in the subprime mortgage market, and higher oil prices, though most forecasters believe that a recession will be avoided. Weighing on the economy will be softer personal consumption, a decline in business inventory levels and a continued contraction in residential investment.
- Consistent with slower economic growth, employment growth has slowed in 2007, and it is widely expected that weakening growth in profits will further curtail hiring. US payroll employment rose 1.0% on a year-over-year basis during December 2007, the slowest pace since April 2004. The national unemployment rate in December 2007 was 5.0%. It is expected to increase in the next year.
- The housing market has weakened significantly this year. Sales of new and existing homes have declined. The inventory of unsold new homes has climbed to high levels, home prices have fallen in many areas, and foreclosures have hit record highs. Conditions in the housing market may worsen in the near future and pose a big challenge to the economy.
- In response to the turmoil in the mortgage and financial markets, the Federal Reserve cut the target federal funds rate in September, October, and December. The Federal Funds rate now stands at 4.25%, 100 basis points below the rate three months ago.
- The stock market performed well in the first three quarters of 2007, with the average daily close of the S&P 500 up 12.7% from the same period of last year. However, as corporate profits are expected to slow due to the housing market decline and credit market turmoil, the growth rates in the stock price indices are expected to fall substantially.

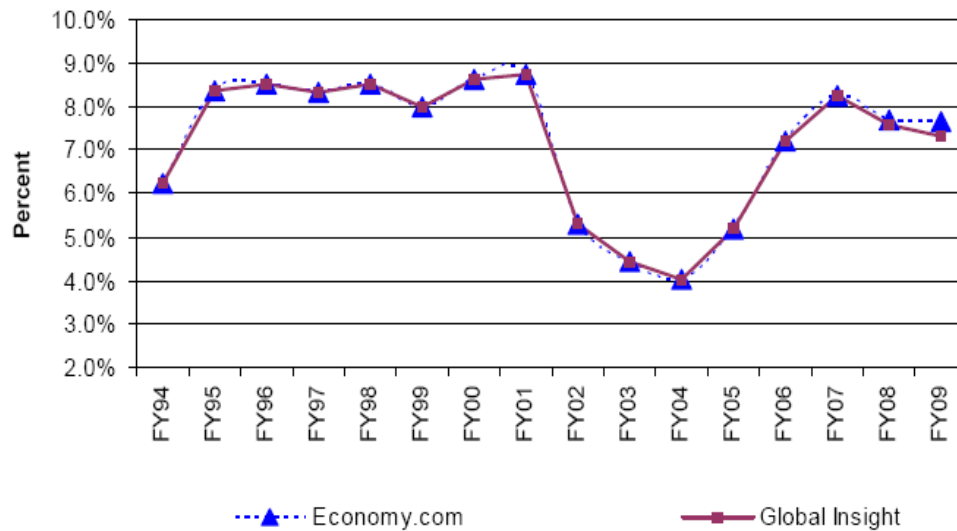
## Real GDP Growth FY1994-09

(Average of Economy.com and Global Insight 11/07 forecasts, beginning FY08)



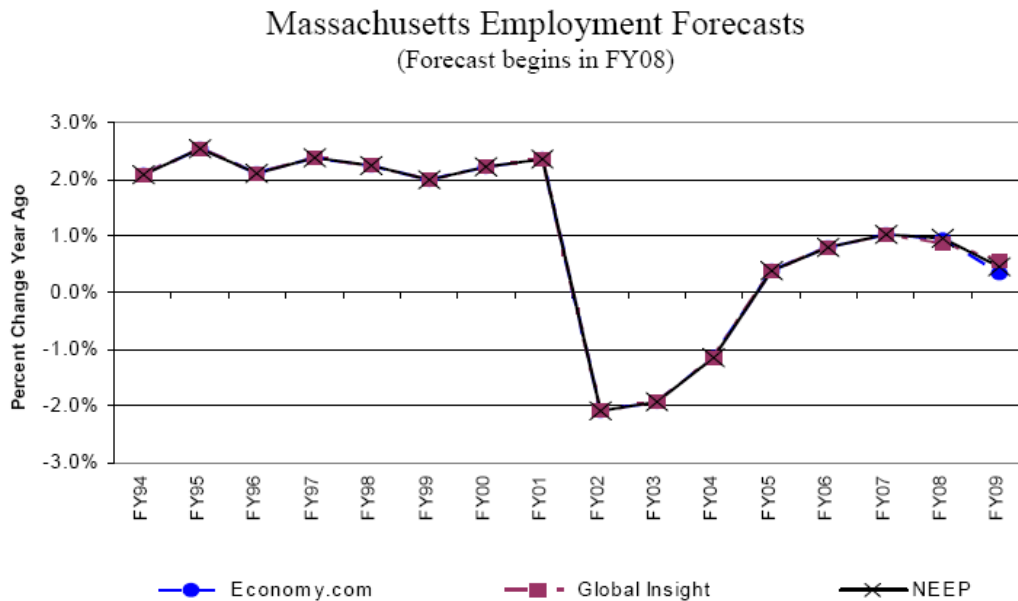
## Interest Rates Will Moderate Through FY09

(Bank Prime Rate)

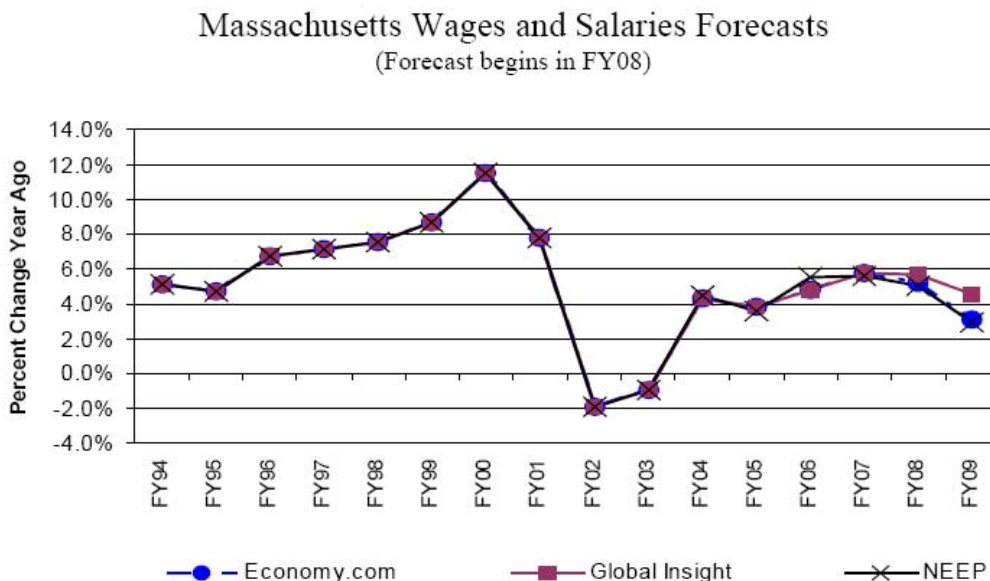


### The Massachusetts Economy

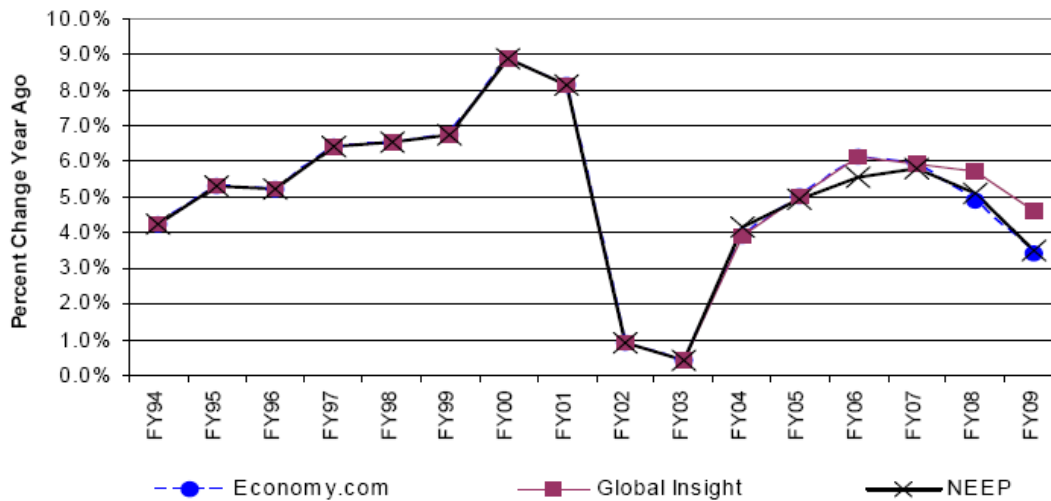
The Commonwealth's employment picture has improved in calendar year 2007. According to the U.S. Department of Labor, state employment in November 2007 grew by 0.9% on a year-over-year basis. Over the same period of time, the unemployment rate decreased from 5.1% to 4.3%.



According to the U.S. Census Bureau's most recent reports, Massachusetts wage and salary disbursements in the second quarter of 2007 increased by 6.9% (compared to the same quarter in 2006) after growing by 6.2% in the first quarter. Personal income increased by 6.2% in the second quarter after growing by 6.4% in the first quarter.



### Massachusetts Personal Income Forecasts (Forecast begins in FY08)



The state's housing market has weakened substantially. According to the Massachusetts Association of Realtors, sales in November 2007 fell by 12.6% for single family homes and 14.2% for condominiums on a year-over-year basis. During the same period of time, the median price fell 2.9% for single family homes and rose 1.9% for condominiums.

Like the national economy, the state economy is expected to grow slowly in 2008 and 2009 as the housing market slump and turmoil in the sub prime mortgage and financial markets impede economic growth through negative effects on construction, household wealth, and consumer spending. Consistent with a slower economy, growth in wage and salary disbursements and personal income are also expected to decline.

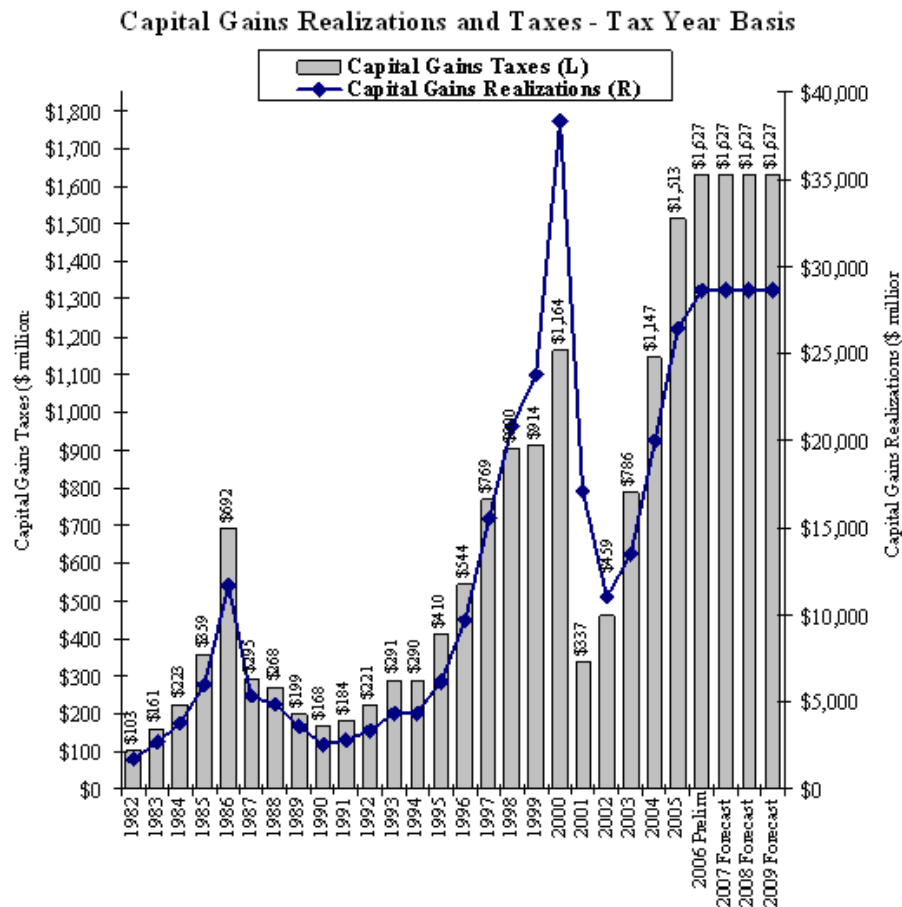
### Massachusetts Real Gross State Product (GSP) Growth FY1994-09 (Forecast begins in CY 2007)



## Capital Gains Taxes

Income tax return data for tax year 2006 received through December 2007 (including data received subsequent to the consensus revenue estimate hearing) indicate that 2006 capital gains realizations were \$28.7 billion, versus \$26.4 billion in tax year 2005, an increase of 8.5%. Capital gains taxes grew from \$1.513 billion in tax year 2005 to approximately \$1.627 billion in tax year 2006 (2006 numbers are still preliminary), a 7.5%, and growth in capital gains taxes from tax year 2005 to 2006 is expected to reach about 10% once all tax returns have been received (the 10% growth assumption is reflected in the capital gains graph below). On a fiscal year basis, fiscal year 2007 capital gains taxes are estimated to have totaled about \$1.668 billion (though no exact numbers are available on a fiscal year basis), an increase of \$104 million, or 6.6%, from fiscal year 2006.

## Capital Gains Taxes

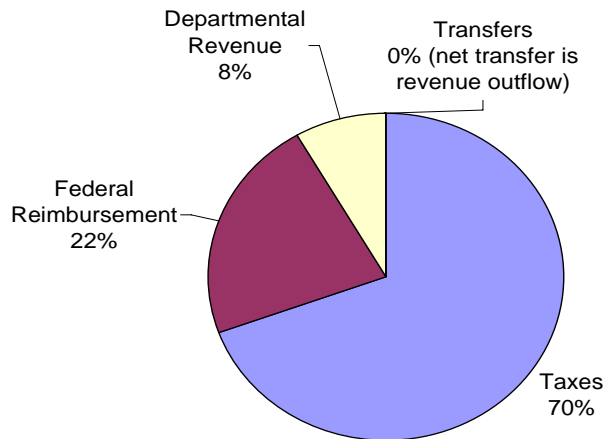


Economy.com (the only economic forecaster that estimates state capital gains realizations) estimates that Massachusetts capital gains realizations will decline by 4% in tax year 2007 and 13% in tax year 2008, then increase by 24.9% in tax year 2009 compared to 2008.

Based on the strength of estimated payments over the past year (which reflects, in part capital gains taxes for tax year 2007), the consensus forecast conservatively assumes that capital gains realizations will be unchanged in tax year 2007 compared to tax year 2006. DOR believes that it is too soon to predict a decline in capital gains realizations for tax year 2008 and an increase in realizations for tax year 2009. The consensus estimated assumes that capital gains realizations will be unchanged from tax year 2007 to tax year 2008 and from tax year 2008 to tax year 2009.

## Non-Tax Revenue Assumptions

In addition to annual state tax revenue, the Commonwealth also collects other forms of revenue that are available for expenditure in the budget. These revenues, grouped as federal reimbursements, departmental revenues and consolidated transfers, account for approximately one third of the Commonwealth's budgeted revenues. House 2 is assuming \$6.895 billion in federal revenues, \$2.577 billion in departmental revenue and a negative \$73 million in consolidated transfers for Fiscal Year 2009.



**Federal revenues** are collected through reimbursement for the federal share of entitlement programs such as Medicaid and through block grants for programs such as Transitional Assistance for Needy Families (TANF). The amount of federal reimbursements to be received is determined by state expenditures for the programs. The Commonwealth receives reimbursement for approximately 50% of its spending for Medicaid programs. Generally, block grant funding is received quarterly and is contingent upon maintenance of effort spending levels determined by the federal government. Staff from the Executive Office for Administration and Finance work with agencies to project budget year spending levels for these federally supported programs.

**Departmental Revenues** are derived from licenses, tuition, fees and reimbursement and assessments for services including, but not limited to revenues from the Registry of Motor Vehicles, reimbursement of healthcare costs from municipalities participating in the state's Group Insurance Commission (GIC) health care programs, drug rebate money received by the Executive Office of Health and Human Services, interest earnings received on the state's budgeted fund balances, and fees collected by the Secretary of State's Office. MGL Chapter 7:3B provides for an annual review of fees to confirm that they are sufficient to defray the cost of providing the service. As part of this exercise, A&F staff analyzes historical non-tax revenue receipts and works with agencies to develop budget year projections for these revenues. Agencies are asked to review and consider during the budget process whether fees and charges:

- cover the full cost of providing a service;
- have been updated recently; and
- are comparable to what other states charge for similar services.

House 2 includes two sections that give a detailed view of projected non-tax revenue for fiscal year 2009. Section 1B details projected fiscal year 2009 non-tax revenue receipts by the department, board, commission or institution that administers and collects the respective revenue source. The online version of House 2 allows the user to further drill down into each governmental area and view a title and description of each revenue source contributing to that area's total non-tax revenue.



**Consolidated Transfers** include a number of operating transfers to and from non-budgeted funds of the Commonwealth. These include transfers to support spending in the Health Care Reform funds including the Commonwealth Care Trust Fund and the Medical Assistance Trust Fund. These inflows and outflows also include annual tobacco settlement proceeds received as part of the Master Settlement Agreement with the tobacco companies, net revenues from the State Lottery Fund, fringe revenue to recoup the cost of various statewide benefit assessed on non-budgeted funds, and revenues from the State's Abandoned Property Division. Staff from the Executive Office for Administration and Finance work with agencies and use historical data to project transfers to and from the budgeted funds for the proposed budget year.

New to this year's budget and added for further transparency, Section 1C details the budgetary impact of these sources and uses of funds.

## Fiscal Year 2009 Expenditure Development

This fiscal year, agencies prepared "Spending Plans" during summer 2007 and filed them with the Executive Office for Administration and Finance for review in September. The spending plans delineate how funds for the current fiscal year will be spent and build upon that base spending to recommend funding for the next fiscal year. Data that is submitted and analyzed includes the following:

- Personnel changes (backfilling or adding new positions)
- Caseload changes
- Increases or decreases in fixed costs (*i.e.* utilities and leases)
- Increased costs and/or full-year costs of new contracts with vendors
- Lawsuits and/or court settlements
- Impacts of new legislation enacted – federal or state
- Changes in regulations – federal or state
- Collective bargaining costs and incremental salary adjustments

In addition, agencies recommended new investment initiatives or savings proposals in their respective spending plans.

A&F develops fiscal year funding recommendations based on analysis of agency spending plan submissions. A critical component for development of the fiscal year 2009 budget recommendation is defining a "maintenance" level of funding for a respective agency or program. A maintenance budget is defined as *the level of funding necessary to provide the same level of services in a fiscal year as those provided for in the prior fiscal year and to cover expenses which the Commonwealth will be obligated to pay*. In defining the projected fiscal year 2009 maintenance level, A&F staff worked closely with counterparts in their respective agencies to monitor and analyze current year spending and revenue collections.

In addition to determining the maintenance level of funding, A&F staff works with agencies to analyze new issues that arise and that may have an impact on upcoming budget recommendations. Here are a few examples of reports and their findings that were incorporated, in part, into the Governor's fiscal year 2009 budget recommendations:

- **Study Commission on Corporate Taxation** – This Commission was created on April 30, 2007 at the joint direction of the Governor, the Speaker of the House and the Senate President to "review and offer recommendations for streamlining the current tax code". The Commission held numerous open meetings, conducted a public hearing at which 46 witnesses testified, formed six committees that heard from many national experts, and ultimately produced a 686-page final report. The recommendations of the Tax Commission have been included in the Governor's budget recommendations and are described in further detail later in this document.
- **State Police Crime Lab Vance Report** – On June 29<sup>th</sup>, 2007, Vance (A Garda Company) released a final report and recommendations regarding their Comprehensive Operational Assessment of the Massachusetts State Police Crime Laboratory System. The report revealed that the Crime Lab had a

severe backlog in DNA cases. Backlogs began in 2004, the year that all felons were first required to submit DNA. To address the significant backlog, the report recommended an increase in staffing as well as supplies. The Governor's budget recommendations included a targeted investment of \$1.5 million to hire additional staff, to reorganize management, and to upgrade technology.

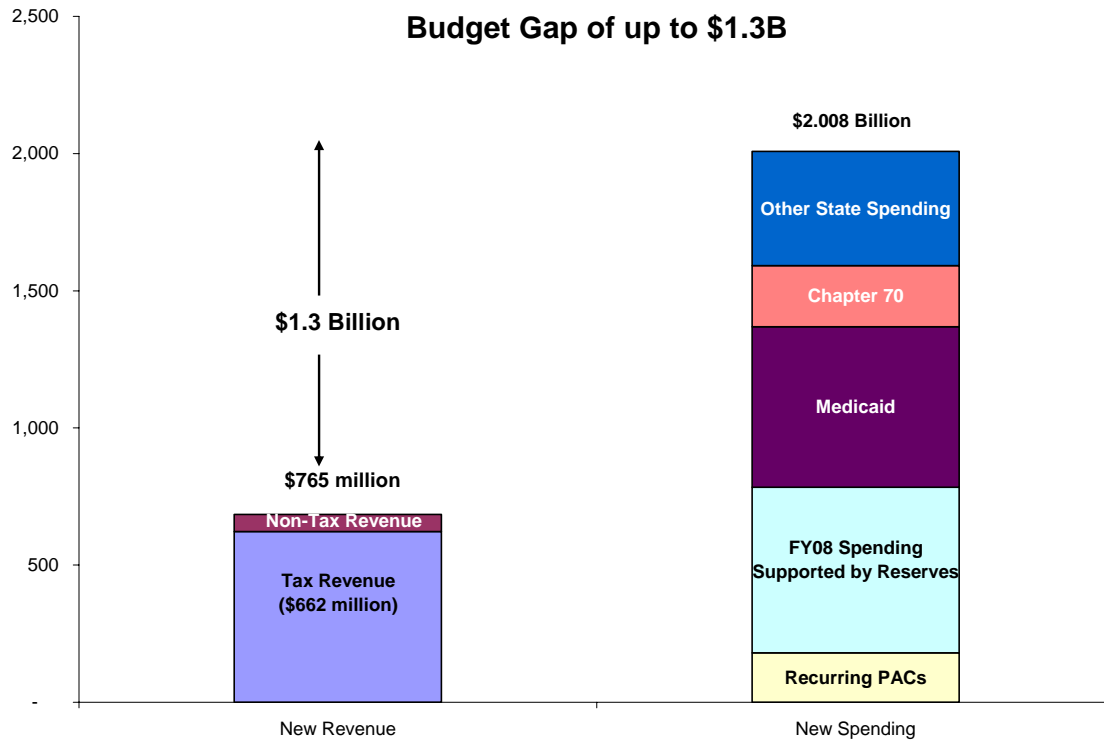
- **Healthy Massachusetts Compact** – This is an interagency agreement between the Executive Office of Health and Human Services, the Department of Corrections, Executive Office for Administration and Finance, the Group Insurance Commission, and the Connector Authority to improve health outcomes through greater coordination and alignment among state health programs. Section 23 of the Governor's budget expands "Pay for Performance" incentives to Community Health Centers and Nursing Homes and plans to align quality and cost incentives run by other public agencies to these facilities.
- **The Visiting Committee on Management in the Courts Report (Monan Report)** -This report, completed in 2003 by a panel of experts, lays out a comprehensive plan for better management of the Commonwealth's court system, including imposing cost and time efficiencies, initiating performance review of individuals and departments and restructuring the Judiciary's line item structure to support these reforms. The Governor's recommendations restructure the line items of the Judiciary consistent with the Monan report recommendations.
- **Report of the Commission to Study the Provision of Counsel to Indigent Persons (Rogers Report)** – This report recommends several reforms in the public defender system, many of which are ongoing and continue to be funded in the H.2 recommendations, including partial funding for recommended private counsel rate increases.
- **The OPEB Commission Report** – Established in the fiscal year 2008 GAA, the OPEB Commission recently released a report that defined "what is facing the Commonwealth in terms of pre-funding other post employment benefits (OPEB), the schedule for such funding, management of assets, potential benefits changes, guidance of for municipalities and future steps to take." The Governor's budget recommendations continue to fund current retiree healthcare costs from the State Retiree Benefits Trust Fund, transferring \$382 million to the Trust to meet projected expenses. While funding current retiree costs from the Trust does not directly reduce the Commonwealth's OPEB liability, consolidating retiree spending will help the Special Commission and other stakeholders better project the Commonwealth's long term obligation.

### **Fiscal Year 2009 Budget Challenge**

The Commonwealth's fiscal year 2008 budget of \$26.808 billion currently relies on about \$600 million of reserve transfers and \$180 million of non-recurring revenues carried forward from fiscal year 2007. In the aggregate, this means that a structural deficit of \$780 million is the starting point for developing a fiscal year 2009 budget that maintains existing services and programs. This does not include spending pressure that exists in fiscal year 2008 from requests for supplemental funding and continued expansion of programs and services.

The fiscal year 2009 budget challenge is compounded by the fact that there are significant pressures on expenditures in fiscal year 2009 for a relatively small number of cost items, including Medicaid, Chapter 70 education aid, and others. Expenditures needed to provide the same level of services in fiscal year 2009 as in fiscal year 2008 are projected to grow by almost 6%, far exceeding the revenue consensus growth of 3.8%.

The structural deficit for fiscal year 2008 together with the projected growth in costs exceeding revenues, not surprisingly, results in a fiscal year 2009 projected shortfall of over \$1.3 billion.



### Fiscal Year 2009 Budget Solutions

The fiscal year 2009 budget authorizes spending of \$28.165 billion, an increase of 5.1% over the fiscal year 2008 General Appropriations Act. Factoring in additional spending now authorized in fiscal year 2008 through supplemental appropriations and prior appropriations continued, the Governor's budget recommendation reflects growth of 3.5% over the current projected spending level for fiscal year 2008.

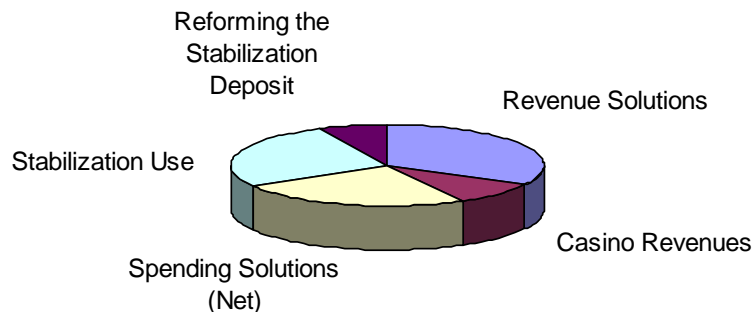
	FY08	FY09 H.2	Variance (H.2 FY08)	H.2 Growth over FY08
<b>Projected Spending</b>				
GAA	26,806	28,165	1,359	5.1%
Prior Appropriation Continued	339			
Year-to-Date Supplementals	75.8			
Reversions/Deficiencies	-18.9			
<b>Total Projected Spending</b>	<b>27,201</b>	<b>28,165</b>	<b>963</b>	<b>3.5%</b>
<b>Projected Revenue</b>				
Consensus Tax Revenue Forecast	20,225	20,987	762	3.8%
Recommendation of the Study Commission on Corporate Taxation		297	297	
Enhanced Revenue Collections and Enforcement Efforts		166	166	
Federal Reimbursements	6,892	6,895	3	0%
Departmental Revenue	2,426	2,578	152	6%
Consolidated Transfers	(220)	(73)	147	-67%
<b>Subtotal</b>	<b>29,323</b>	<b>30,849</b>	<b>1,526</b>	<b>5.2%</b>
Less MBTA	(756)	(768)	(12)	2%
Less SBA	(635)	(702)	(67)	11%
Less Pensions	(1399)	(1465)	(66)	5%
<b>Total Projected Revenue</b>	<b>26,533</b>	<b>27,914</b>	<b>1,381</b>	<b>5.2%</b>

The Governor's fiscal year 2009 budget proposal relies on a balanced set of solutions to close the projected shortfall describe earlier. The Governor's budget recommendations are balanced and transparent. The

Administration restrained spending through a variety of initiatives that resulted in gross reductions of \$479 million (\$344 million net) or almost 2% of state spending. This combined with revenue initiatives, spending controls, reforming the Stabilization Fund deposit, and a rational approach to the use of reserves combined to close a \$1.3 billion gap.

In addition to these solutions, the budget holds nearly 190 line-items to zero growth in spending for fiscal year 2009. Base spending for these items total almost \$1.5 billion in fiscal year 2009.

## Balanced Approach



The Solutions:		(millions)
<b>A. Spending Controls and Reductions</b>		
Elimination of Earmarks	\$	(40)
State Employee Health Care Contributions	\$	(51)
Constrained growth in agency & program spending	\$	(84)
<b>B. Medicaid Cost Controls and Savings - (Net of Revenue Loss)</b>		
Value and Cost Based Purchasing Principles	\$	(105)
Right Care, Right Setting Efficiencies	\$	(26)
Efficient Drug Utilization	\$	(10)
Administrative Savings	\$	(29)
<b>Subtotal of Spending Controls and Reductions (\$479M Gross Savings)</b>	<b>\$</b>	<b>(344)</b>
<b>C. Enhanced Revenue Collection and Enforcement Efforts</b>	<b>\$</b>	<b>(166)</b>
<b>D. Recommendations of the Study Commission on Corporate Taxes</b>	<b>\$</b>	<b>(297)</b>
<b>E. Casino Revenues Used to Cover the Lottery Shortfall</b>	<b>\$</b>	<b>(124)</b>
<b>F. Stabilization Use - In Accordance with Administrations Proposed Policy</b>	<b>\$</b>	<b>(369)</b>
<b>G. Reforming the Stabilization Fund Deposit</b>	<b>\$</b>	<b>(100)</b>
<b>Total Solutions:</b>	<b>\$</b>	<b>(1,399)</b>

**Note:** Total savings cover the budget gap along with limited targeted investments

### **A. Spending Controls and Reductions**

This budget holds growth in agency and program budgets by, in some cases, reducing maintenance levels of spending that result in aggregate cost savings of \$479 million gross savings (\$344 million net).

#### ***Employee Health Care Contributions (\$51 million)***

The budget offers comprehensive, affordable health insurance coverage to state employees through the Group Insurance Commission, while including reforms to improve the fairness and sustainability of health coverage for state employees. The budget changes employee contributions from a system based on date of hire to a more rational system based on salary levels and affordability. The following table shows the proposed employee contribution level, which could result in \$51 million of budget savings:

Salary Level	Employee Contribution
<\$35,000	15%
\$35,000-\$50,000	20%
>\$50,000	25%

This reform would *reduce* contributions for 6,000 state employees – and for another 16,000 state employees, contribution levels would not change. For many other state employees, contribution levels would increase modestly based on salary and affordability. In the aggregate, these reforms would reduce system costs by \$51 million in fiscal year 2009, better positioning the Commonwealth over time to continue to provide comprehensive health insurance to state workers.

#### ***Elimination of Earmarks (approximately \$40 million)***

The budget eliminates \$40 million of earmarks enacted through last year's budget removing earmarks that, however well-intentioned, were inconsistent with the mission of the agency under which they were funded or otherwise not affordable in a challenging budget year.

#### ***Additional Spending Controls (\$84 million)***

There are over 50 line items where reductions from maintenance levels of spending result in a total of \$84 million in savings therefore slowing the growth in these agencies and programs. Additionally, the budget holds nearly 190 line items to zero growth in spending for fiscal year 2009. Base spending for these line items totaled almost \$1.5 billion in fiscal year 2008.

### **B. Medicaid Cost Controls and Savings**

This budget includes \$303 million in gross savings (\$168 million in net savings), and \$33 million in net investments necessary to achieve those savings in our state's Medicaid program (MassHealth). These savings helped to control the overall growth in MassHealth from a projected 8.4% increase to a more affordable 5.2% over last year's projected spending levels.

Examples of MassHealth cost containment initiatives include the following:

- *Value and Cost-Based Purchasing (\$203 million gross/ \$105 million net)*: Reimburses all providers with fair and efficient rates, eliminates special rate earmarks that circumvent the rate-setting process, and focuses on achieving quality performance from all providers. Additional investments of \$7 million are needed to accomplish these savings.

- *Right Care, Right Setting (\$52 million gross/ \$26 million net)*: Provides needed care to individuals in the most appropriate setting, and focuses on chronic disease management as an opportunity to provide better services. Additional investments of \$14 million (\$7 million net) are needed to accomplish these savings.
- *Efficient Drug Utilization (\$19 million gross/ \$9.5 million net)*: Focuses on drug utilization management and substitutes medically appropriate generic drugs where possible.
- *Administrative Savings (\$28.5 million gross)*: Implements one-time savings related to the implementation of NewMMIS, the system used to make Medicaid payments and draw down FFP.

### **C. Enhanced Revenue Collections**

The Governor's budget includes enhanced revenue and enforcement initiatives that are expected to generate \$166 million in additional revenue in fiscal year 2009. These initiatives are described below:

#### ***Additional Tax Auditors Initiative (\$60 million)***

Additional auditors hired at the Department of Revenue (DOR) in fiscal year 2008 will result in \$60 million in new revenue for fiscal year 2009. The enacted fiscal year 2008 budget authorized DOR to hire 87 more tax auditors to promote better enforcement of the tax code and improve collection efforts. Although some newly hired auditors have already been working toward these efforts, most of the auditors will not be on board until the 2009 tax season. These additional auditors are projected to generate an additional \$60 million for the General Fund.

#### ***Tobacco Tax Enforcement Proposals (\$33 million)***

- *Encrypted Tobacco Stamps* - Tobacco stamps are used to show payment of taxes. DOR sells stamps to licensed stampers who then affix the stamps on cigarettes before they can be sold in stores. The current stamp technology is easy to counterfeit and therefore ineffective. As a result, the state loses millions of dollars when cigarettes are smuggled into the state and sold with counterfeit stamps. New technology has created encrypted stamping methods that allow the stamp to be tracked from the time it is sold to a stamper through the sale of the product at the retail level. Utilizing this encryption will enable DOR to track cigarette packs throughout distribution to ensure proper tax collection. An investment to purchase the encrypted stamps and to hire and train compliance staff will yield \$12 million in fiscal year 2009 and \$24 million annually when fully implemented.
- *Taxing Cigars and Smoking Tobacco at the Wholesale Level* - Cigars and smoking tobacco excise taxes are collected in Massachusetts at the retail level, in contrast to excise taxes on cigarettes and smokeless tobacco, which are collected at the wholesale level. Additionally, while the law requires the licensing of dealers in cigarettes and smokeless tobacco, it does not require the licensing of dealers in cigars or smoking tobacco. The enforcement and collection efforts are difficult because the cigar and smoking tobacco excise is imposed on roughly 4,000 retailers and because the lack of licensing makes tracking of sales and purchases between dealers and identification of non-filers virtually impossible. In fiscal year 2009, DOR proposes to impose these excise taxes at the wholesale level and require the licensing of those wholesalers. As a result, DOR can implement better enforcement and estimates that revenue will increase by \$11 million in fiscal year 2009.
- *Prepaid Sales Tax on Cigarettes* - Collecting sales taxes from the myriad of local cigarette retailers poses a challenge for the Department of Revenue. Retailers may be unlicensed or under-report, making it difficult for the Department to audit, to enforce, and to collect cigarette sales taxes. For fiscal year 2009, DOR will require wholesalers of cigarettes to charge and collect a prepaid sales tax from retailers of cigarettes. Because the number of wholesalers is significantly less than the number of retailers, collections and enforcement activities can be simplified. With this change, DOR estimates that tobacco tax revenue will increase by \$10 million in fiscal year 2009.

### ***Wage Enforcement Efforts (\$30 million)***

Misclassification of employees by employers has resulted in millions of dollars in lost tax revenue each year. Some employers are not following state laws and are inappropriately hiring workers as independent contractors instead of as full time employees. This practice is advantageous for employers since they do not have to pay withholding taxes and are able to avoid paying benefits such as health care and worker's compensation. The Attorney General's Office (AG), along with DOR, the Department of Industrial Accidents (DIA), and the Division of Unemployment Assistance (DUA) will fully implement a statewide initiative to address this ongoing problem. The AG's office along with DOR will make a more visible effort to enforce employee classification laws. The increased public efforts will signal to violators that addressing this problem is a priority for the Commonwealth. As a result, voluntary compliance is expected to increase. Violators will be given the opportunity to comply with the existing laws through a yet-to-be designed program. DOR expects voluntary compliance to be significant since employers would rather come into compliance than face stiff penalties if caught. As a result of this enforcement initiative, DOR expects tax revenue to increase by \$30 million. The initiative is modeled after a similar program implemented in New York.

### ***Recording of Liens (\$6 million)***

The Department of Revenue imposes liens on homeowners who owe taxes to the state. DOR will initiate a special project to file liens against delinquent taxpayers with outstanding debts of over a specified level. To date, DOR has focused on targeting taxpayers that owe more than a specific amount. Filing liens is a manually intensive process as DOR is required to file liens with a property owner's local governing authority. DOR plans to redeploy its employees to create the required staff hours necessary to manually file liens. There are approximately 21,000 people with tax due under DOR's specified amount, for a total of \$63 million owed. As a result of the new enforcement initiative, DOR expects to collect \$6 million in fiscal year 2009.

### ***Increasing Penalties on Tax Evaders (\$25 million)***

- Late-Pay Penalties – DOR has the authority to charge penalties against taxpayers who fail to file returns or make payments in a timely manner. Failure to pay an amount reported on a return and failure to pay a deficiency assessment within 30 days of notice generates a penalty of 0.5% per month on unpaid balances. DOR plans to increase these penalties to 1%. As a result of the increase, DOR estimates that revenue will increase by \$12 million.
- Demand Fees – DOR is permitted to add a one-time fee to unpaid taxes requiring collection activity. DOR is proposing to increase the demand fee from \$5 to an amount not to exceed \$30. This new amount is more in line with industry standards. As a result of the increase, DOR estimates that revenue will increase by \$4 million.
- Driver's License Revocation – These changes provide that the Registry of Motor Vehicles will suspend a driver's license for nonpayment of taxes upon notification from DOR. Revocation will be integrated into the existing collections process. Evaders will be given at least 30 days notice of any proposed action. The threat of revocations will create a strong incentive for tax evaders to make payments to the Commonwealth. DOR has the authority to revoke the driver's licenses of non-custodial parents that owe child support payments. This tool has been effective in collecting past due child support, and DOR expects it to be equally effective in collecting general tax revenue owed to the state. DOR estimates that the proposal will result in a \$7 million increase in tax revenue.
- Withholding on Real Estate Sales Tax – DOR is currently not collecting the maximum amount of taxes from out-of state residents and corporations when they sell their property in the Commonwealth simply because it is more difficult to track out of state buyers/sellers. Because tracking is difficult, DOR needs to better ensure that out-of-state entities have paid the appropriate amount of taxes upon sale of their property. To address this problem, DOR intends to submit a regulation change that will allow them to withhold an amount of taxes upon purchase for out-of-state buyers. As a result, DOR anticipates

additional and appropriate tax collections on these types of transactions will increase revenue by \$2 million in fiscal year 2009.

#### ***Reducing Tax Exemptions (\$12 million)***

- *Aircraft and Parts Sales Tax Exemption* – This change revokes sales and use tax exemptions for aircraft and replacement parts for aircraft enacted in 2001. In some instances, the exemption has resulted in the loss of the entire sales or use tax on an aircraft to another jurisdiction. This change also gives the Commissioner of Revenue authority to impose a tax in situations where an aircraft is placed in an LLC or corporation for state tax avoidance purposes. DOR estimates that the proposal will result in a \$9 million increase in tax revenue.
- *Pesticides Sales Tax Exemption* – This change would eliminate the exemption for household insect sprays and lawn chemicals except when purchased by farmers and licensed applicators, increasing tax revenue by almost \$3 million. Pesticides may cause health and environmental problems, and their use should not be encouraged through a broad tax exemption.

#### ***D. Recommendations of the Study Commission on Corporate Taxation***

The Governor has filed companion legislation to his budget proposal to close corporate tax loopholes that allow avoidance of business tax laws passed by the Legislature. This bill also gradually reduces the business tax rate from 9.5 to 8.3 percent to improve Massachusetts' business competitiveness. These significant tax reforms serve several important public policies including:

- Tax Fairness – All businesses will pay their fair share of the costs of government that benefit them and all of us, and larger and out-of-state businesses will pay at the same rate as smaller and Massachusetts-based businesses.
- Modernization – Massachusetts will join the 21<sup>st</sup> century and the national tax-policy mainstream. Twenty-two other states, including virtually all Massachusetts' competitors, have already adopted combined reporting, and nearly every other state follows the federal check-the-box rules.
- Competitiveness – The substantial rate reductions will help Massachusetts businesses, especially smaller and in-state ones, compete in the global economy.
- Adequate Revenue – Although some of the new revenue raised by these reforms is being returned to business taxpayers through lower rates, the remainder will help the Commonwealth pay for important investments and public services that benefit businesses and all citizens – like health care, job creation, affordable housing, education, and transportation.

#### ***Business Tax Reforms (\$297 million)***

The two main proposed reforms are:

- Combined reporting – This reform prevents strategies by multi-state businesses to shift income away from corporations doing business in Massachusetts to affiliates in low-tax jurisdictions, thus reducing their taxes paid in Massachusetts. It requires affiliated corporations engaged in unitary business activities to combine their incomes and file as one entity.
- Check-the-Box Conformity – This prevents businesses from filing federal and other-state tax forms as corporations while claiming another status on their Massachusetts tax returns.

In addition, the Governor's bill prevents Internet retail agents from avoiding the hotel/motel tax on the full price of a room as charged to the consumer (\$6 million), and clarifies that the earned income tax credit is available only to Massachusetts residents (\$2 million).



### ***Corporate Tax Rate Reduction***

The Governor also proposes reducing the Massachusetts corporate tax rate from 9.5 percent, nominally the fourth-highest in the nation, to 8.3 percent over the three years after this one. By the standard of total business taxation – currently 40<sup>th</sup> highest in the nation – Massachusetts will remain among the most economically competitive states. These lower rates, eventually a 13 percent tax reduction, will especially help smaller and Massachusetts-based businesses, which the loopholes closed by this bill have generally not benefited.

### ***E. Casino Revenues Used to Cover Lottery Shortfall***

Over the last 20 years, the Massachusetts State Lottery has generated an invaluable source of resources for the state's municipalities to fund essential programs and services to their communities. While experiencing tremendous growth over time, recently the State Lottery's revenue growth has slowed moderately. In fiscal year 2007 and fiscal year 2008, lottery revenues were not sufficient to fully fund programmed distributions to municipalities, and a similar deficit is projected in fiscal year 2009, totaling \$124 million. In recognition of the fact that communities are relying on \$935 million in Lottery Funds to support local budgets, the Governor's H.2 recommendation uses \$124 million in casino licensing revenues, together with projected lottery receipts of \$811 million, to fund a total local aid distribution of \$935 million in fiscal year 2009.

It should be noted that the State's commitment to cities and towns is to distribute uncapped net lottery revenues to them for unrestricted use to support their municipal budgets. Based on current projections of fiscal year 2009 net lottery receipts, a distribution to cities and towns of \$811 million would satisfy this commitment. The Governor, however, recognizes the fact that municipalities have come to rely on an aggregate distribution of \$935 million. Although the Commonwealth cannot afford to fund the expected shortfall with existing state resources, passage of the Governor's casino proposal would provide new state revenues that the Governor proposes to dedicate in part to funding this shortfall. The one-time license fees can be used to supplement the Lottery over the next 3 years, during which time Lottery growth is projected to grow to the point where this supplemental funding will no longer be needed.

### ***F. Stabilization Fund***

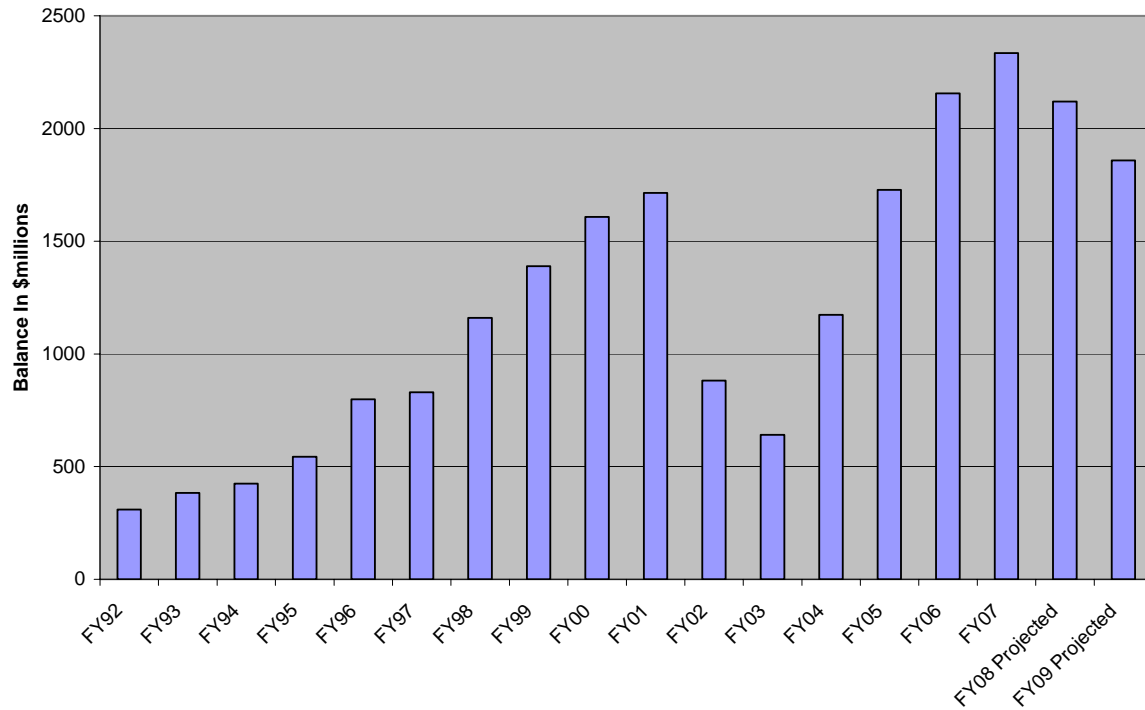
As a part of the balanced approach to solving the fiscal year 2009 budget challenge, the Governor's budget proposal includes a \$369 million transfer from the Stabilization Fund. The amount of the transfer is based on a fiscally responsible approach to the use of the Stabilization Fund to support budgeted spending. The following is a general description of the Stabilization Fund and of the Administration's policy for determining the appropriate amount of the budgeted transfer from the fund.

#### ***General Information regarding the Stabilization Fund***

The Stabilization Fund is established in Chapter 29, section 2H of the General Laws as a reserve of surplus revenues to be used for the purposes of: (1) covering revenue shortfalls, (2) covering state or local losses of federal funds, or (3) for any event which threatens the health, safety or welfare of the people or the fiscal stability of the Commonwealth or any of its political subdivisions. The fund is sometimes referred to as the state's "rainy day fund," serving as a source of financial support for the state budget in times of slow or declining revenue growth and as the primary source of protection against having to make drastic cuts in state services in periods of economic downturns.

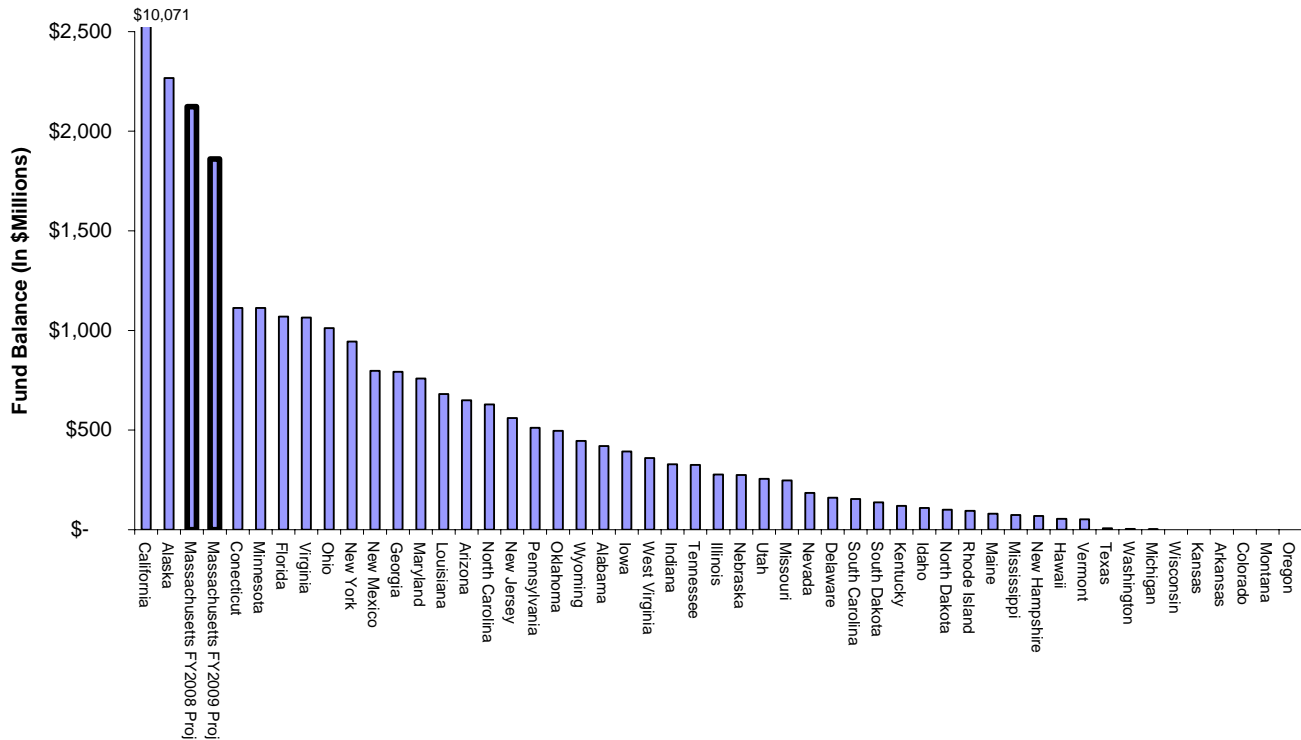
The following table shows the amount on deposit in the Stabilization Fund at the end of each of the last 16 fiscal years and the projected balance for fiscal years 2008 and 2009.

### Stabilization Fund Balances Since FY92

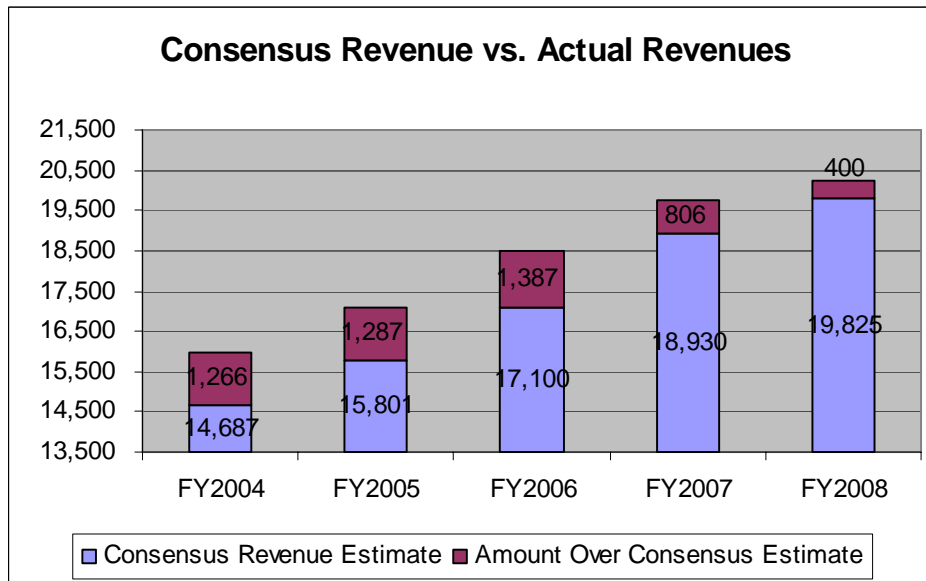


As indicated in the table above, amounts in the Stabilization Fund provided critical support in maintaining state services in fiscal years 2002 and 2003 when the Commonwealth experienced declining tax revenues in the face of an economic downturn. Since then, surplus revenues have built the fund back up to a healthy balance of \$2.335 billion at the end of fiscal year 2007, the third highest reserve fund balance of any state in the nation. The fiscal year 2008 budget proposes to use \$240 million from stabilization and \$75 million of interest from the stabilization fund for a total of \$315 million (this does not include the \$100 million deposit not made in fiscal year 2008 as it does not draw from the balance of the fund) bringing the fiscal year 2008 balance to 2.123 billion. For fiscal year 2009 the Governor's budget recommendations rely, to the extent needed, on \$370 million of stabilization funding while maintaining the third highest balance in the nation of 1.861 billion.

## Budget Stabilization Funds



In recent years, budgeted state spending has exceeded projected revenues and has relied to some extent on the use of Stabilization funds. However, in fiscal years 2004 through 2007, actual state tax revenues exceeded the consensus revenue estimates upon which the budget was developed, ultimately avoiding the need to transfer amounts from the Stabilization Fund to support budgeted spending.



The Governor's budget proposal for fiscal year 2008 relied on \$175 million from the Stabilization Fund (\$100 million from suspending the deposit and \$75 million from interest earnings on the fund), but the final approved fiscal year 2008 budget enacted by the Legislature calls for a \$415 million transfer (\$100 million from suspending a required deposit to the fund, \$75 million from the interest earnings, and a \$240 million draw from the balance of the fund). The Commonwealth has already transferred \$240 million from the fund to support fiscal year 2008 spending, and it remains to be seen whether state tax revenues will exceed the revised projections for the remainder of fiscal year 2008 to the extent necessary to eliminate the need for further Stabilization Fund transfers or even to reimburse the Stabilization Fund for the amount already transferred. So far, the fiscal year 2008 consensus revenue estimate has been revised upward by the Secretary of Administration and Finance and is currently performing slightly above benchmark as of December.

### ***Policy for Stabilization Fund Use in the Fiscal Year 2009 Budget***

The Stabilization Fund should be used judiciously and responsibly to sustain critical state services and programs in the face of changing economic conditions and fluctuating tax revenues. The Commonwealth's prudent funding and use of the Stabilization Fund allowed the Commonwealth to weather the economic downturn in the early years of this decade much more easily than most of the other states in the nation. It is in the long-term financial interest of the Commonwealth to preserve and build a healthy rainy day fund balance in years of strong revenue growth to assist the Commonwealth in weathering future economic storms.

As outlined earlier, the consensus revenue process projects the underlying revenues that support nearly 2/3 of the budget. The accuracy of the consensus tax revenue estimate upon which the budget is based is a key factor influencing whether there will be a surplus contributing to the balance of the Stabilization Fund or a need to draw on the fund. Although this estimate is based on economic models and advice from various experts, it is made 6 to 18 months before the related fiscal year and is consequently unlikely to predict actual tax revenues with precision. As indicated above, consensus tax revenue estimates have been well below actual revenues in recent years. As a result, the Legislature has been enacting budgets that rely on the use of Stabilization Fund transfers which have ultimately not been needed. In addition, large year-end surpluses have been generated and a large portion of these surpluses have been expended outside of the context of the budget-making process through which all state funding priorities are taken into account and weighed against each other. This recent trend in under-estimating tax revenues and ad hoc spending of large year-end surpluses contributes to public skepticism about the budgeting process. It also raises questions about the circumstances under which it is appropriate to rely on amounts in the Stabilization Fund for budgetary purposes.

The primary purpose of the Stabilization Fund is to preserve the fiscal stability of the Commonwealth. In the context of less than certain consensus tax revenue estimates, the Administration believes that the use of the Stabilization Fund as a resource to support the budget can be justified as a means of providing overall budgetary stability. However, the amount of any such budgeted transfer from the Stabilization Fund should be linked to the consensus tax revenue estimate and viewed in the context of historic tax revenue trends to ensure that the planned use of the fund is not excessive.

The following describes the methodology used by the Administration for purposes of determining the appropriate Stabilization Fund amount to support the fiscal year 2009 budget:

- Transfer an amount from the Stabilization Fund that, together with the amount of estimated growth in fiscal year 2009 tax revenues, as determined in the consensus revenue forecast, over the revised fiscal year 2008 tax revenue estimate, will equal the historic annual average growth in actual state tax revenue collections over the last five fiscal years.
- The revised tax revenue estimate for fiscal year 2008 is \$20.225 billion, and the consensus revenue estimate for fiscal year 2009 assumes 3.8% growth, or \$762 million more than fiscal year 2008 (\$20.987 billion).

**Historic Tax Growth:**

<b>Fiscal Year</b>	<b>Total Collections (\$ in millions)</b>	<b>Growth (%)</b>	<b>Growth (\$ in millions)</b>
2002	14,287		
2003	14,964	4.7%	677
2004	15,953	6.6%	989
2005	17,088	7.1%	1,135
2006	18,488	8.2%	1,400
2007	19,736	6.8%	1,249
<b>5 year Average</b>		<b>6.7%</b>	<b>1,131</b>

The calculation for determining the maximum amount from the Stabilization Fund that may responsibly be used:

1. Reach agreement on Consensus Revenue Forecast:

FY2008	\$	20,225
FY2009 - 3.8% Growth	\$	20,987
New Tax Revenues for FY2009:	\$	762

2. Determine the actual growth in tax revenue over the past 5 years and develop the average (as shown in chart above) \$ 1,131
3. Subtract the new tax revenue growth from the 5 year average of actual tax revenue growth \$ 369
4. This is the maximum amount of Stabilization Funds that may responsibly be used: \$ 369

***Benefits of the Stabilization Fund Policy in the Fiscal Year 2009 Budget***

This approach to budgeting for a Stabilization Fund transfer is fiscally responsible. It provides for budget stability by taking into account the inherent uncertainty of the consensus tax revenue estimate and historic revenue growth trends, and it provides for budget stability in both an increasing and decreasing revenue environment. If tax revenue estimates are too conservative and revenues come in higher than projected as has been the case in recent years, the need to transfer from the Stabilization Fund to support the budget will be reduced or eliminated. If the consensus tax revenue estimates are correct and revenues are less than the five-year historic average, we will need to use Stabilization funds to support base spending and budget stability.

This approach also ensures that the budget is not based on an excessive use of amounts in the Stabilization Fund. By linking the budgeted transfer to the consensus tax revenue estimate and the five-year historic average annual growth in tax collections, this policy ensures that we are not using the Stabilization Fund to support spending beyond what historic trends suggest can be supported by revenues.

In recent years, there has been no rationale behind the amount of Stabilization Fund transfers supporting the budget. This approach provides a fiscally responsible and transparent rationale for the use of the fund.

***G. Reforming the Statutorily Required Deposit into the Stabilization Fund***

M.G.L. Chapter 29 s5C subparagraph (a )provides that ½ of 1 percent of the total revenues from taxes in the preceding fiscal year be deposited in to the Stabilization Fund. It is important to build up the Commonwealth

Stabilization Fund to help cushion the impact of an economic downturn. At the same time, our contributions to growing the fund must be made strategically and weighed against other targeted investments for which those funds could be used to help grow our economy. In this budget, the Governor proposes to amend this provision by allowing investment earnings on the balance of the fund to count toward the statutorily required deposit. This policy ensures that when the fund is at its highest levels, as it has been in recent years, the interest earnings, along with a more modest deposit, should be enough to support continued growth in the fund. Conversely, when the fund balance is at its lowest levels and we cannot rely on investment earnings to help grow our savings a larger deposit would be required. Overall, this policy ensures that limited resources are invested wisely. For fiscal year 2009 the scheduled deposit is estimated to be \$107 million and interest earnings are projected to be approximately \$100 million. That would mean that a deposit of approximately \$7 million will be made for fiscal year 2009.

## HEALTH CARE REFORM

Including a section discussing the implementation and costs of the Commonwealth's historic health care reform law in this document reflects the fact that health care reform is a signature initiative for Massachusetts. The Commonwealth is leading the nation in expanding health coverage for the uninsured, with the goal of offering high-quality, affordable coverage to nearly every resident of our state.

Discussing health care reform in this document also reflects the fact that this initiative has considerable financial implications for Massachusetts. Even with success in realigning some state investments from funding sporadic uncompensated care to providing subsidized health insurance, health care reform has clearly required new financial commitments on the part of state government. The fiscal year 2009 budget reflects both the Administration's continuing commitment to the success of health care reform and also the growing public costs of this ambitious endeavor.

### *Progress to Date*

In April of 2006, Massachusetts enacted groundbreaking health care reform legislation aimed at making affordable health coverage available to nearly every citizen of the Commonwealth. Since health care reform was signed into law, a broad array of stakeholders – including providers, insurers, businesses, advocacy and community organizations and government agencies – have worked together to implement this historic legislation. As a result of these efforts, in less than two years, it is estimated that over 300,000 previously uninsured residents have gained access to health coverage and care.

Health care reform included many strategies to expand coverage and access to care for the uninsured, including expanding eligibility for health insurance through our state's subsidized MassHealth program and restoring MassHealth coverage for benefits that had previously been scaled back. The MassHealth program has taken significant steps to enroll residents who are eligible for coverage, including nearly 24,000 children (for whom income eligibility was expanded under health reform).

Lower-income individuals have also secured health insurance through the new Commonwealth Care program, which offers subsidized coverage to residents whose incomes are at or below 300% of the federal poverty level. As of January 1, 2008, over 169,000 residents have signed up for coverage through Commonwealth Care – reflecting greater-than-expected success in enrolling eligible individuals in this program and offering them new opportunities to access affordable care.

Health care reform not only offered new opportunities for subsidized coverage to low-income residents but also made significant reforms to the insurance market to reduce the cost of commercial insurance for residents who are not eligible for publicly-supported coverage. Residents between the ages of 18 and 26 who do not have access to insurance can sign up for new, more affordable Young Adult Plans (YAPs) through the state's Health Connector. The legislation also combined the individual and small group insurance markets, expanding the risk pool for coverage and stabilizing prices for this group.

Health care reform allowed for new products to be offered through the Health Connector to individuals and families whose income exceeds eligibility for Commonwealth Care but who do not have access to employer-sponsored insurance. Six of the state's major health insurance carriers offer health plans through the Health Connector's Commonwealth Choice program. As of January 1, 2008, nearly 16,000 residents had enrolled in Commonwealth Choice plans.

Health care reform also includes an "individual mandate," requiring adults who can afford health insurance to have coverage or pay a tax penalty. For 2007, the penalty for adults who did not have health insurance coverage in force as of December 31, 2007 is the loss of their personal tax exemption (a penalty of \$219 per individual). Residents will indicate whether or not they had health coverage as of that date (or were exempt) when completing and submitting their 2007 tax forms in early 2008. For 2008, penalties will increase substantially and accrue for every month an adult lacks health coverage.

In addition to requiring individuals to maintain health insurance coverage, health care reform also imposes new responsibilities on employers. Employers with eleven or more full-time employees must make a fair and reasonable contribution to their employees' health insurance or pay an annual assessment to the state (this is known as the "fair share" requirement). They must also allow their employees to pay their portion of health premiums on a pre-tax basis (pursuant to Section 125 of the Internal Revenue Code).

#### *Funding in Fiscal Year 2009 H.2 Recommendation*

The Administration has invested over \$2.6 billion in health care reform in House 2, reflecting its strong support for this groundbreaking initiative. House 2 includes:

- nearly \$900 million within MassHealth appropriations to continue funding for the MassHealth eligibility expansions and benefit restorations included in health care reform and provide the final year of statutorily specified rate increases for providers.
- \$869 million for Commonwealth Care to provide coverage to nearly 225,000 residents.
- \$453 million to provide care through the Health Safety Net Trust Fund as an essential safety net for residents who do not at this time have access to affordable health insurance coverage.
- \$439 million to provide supplemental payments to several safety net hospitals, including \$160 million in supplemental payments required by S.122 of the health care reform legislation. Other supplemental payments are funded through the Medical Assistance Trust Fund and Essential Community Provider Trust Fund and are intended to encourage coordinated, community approaches to providing care to areas with high concentrations of MassHealth and Commonwealth Care enrollees.

#### *Areas to Watch*

Health care reform is an unprecedented initiative. In implementing all aspects of health reform, we are cognizant that Massachusetts is breaking new ground; that we will learn much about its impact and costs during the actual course of implementation; and that we must maintain the flexibility to adjust and adapt based on actual experience and data.

Along these lines, we are continuing to monitor funding needs for health care reform in light of the actual experience of implementation, examining factors such as levels of enrollment in health insurance and the utilization and cost of services.

- Enrollment in Commonwealth Care has been very strong to date, already significantly exceeding initial fiscal year 2008 year-end estimates. The Administration and the Connector will continue to monitor actual enrollment in Commonwealth Care over the next few months to better assess year-end enrollment and cost scenarios. The Administration's fiscal year 2009 budget is based on revised, more recent enrollment scenarios for Commonwealth Care for fiscal years 2008 and 2009.
- Based on filings received thus far, year-to-date fiscal year 2008 "fair share" liability for businesses totals slightly over \$5 million, relative to \$23.9 million estimated in the budget for fiscal year 2008 as a whole. The Administration has assumed \$5 million in "fair share" revenues for fiscal year 2009, a conservative estimate consistent with revenues received to date under the Division of Health Care Finance and Policy's current "fair share" regulations.

Among other things, these developments are causing health care costs to consume an ever-growing portion of the state budget. In fiscal year 2008, health-related costs accounted for 45 percent of the state budget, not counting the portion of Local Aid that effectively funds rapidly escalating municipal employee health insurance costs. It is critical that we "bend this cost curve" in a more sustainable direction, so we can continue on the path of expanding health insurance coverage and also have sufficient resources to invest in other public priorities.

The fiscal year 2009 budget does contain over \$300 million in gross savings (over \$160 million in net savings) in the MassHealth program, achieved by paying providers fair and accurate rates for health services, providing the right care in the right setting, and more efficiently managing the costs of prescription medications. However, we



will need to make additional progress in containing health care costs, requiring resolve from everyone who has a stake in the success of health reform *and* the capacity of state government to address the full range of challenges facing Massachusetts. The Administration looks forward to working collaboratively with the Legislature and other stakeholders to make historic progress in making health care more affordable for government at every level, businesses, and our families.

As it wrestles with the challenge of health care cost containment, the Administration also continues to work with stakeholders to implement and monitor the impact of other provisions of health care reform. For example, the Department of Revenue is beginning to process 2007 tax returns – on which residents will indicate whether or not they had health insurance as of December 31, 2007. Individuals who did not have health coverage as of that date and face the loss of their personal tax exemption based on state affordability guidelines may file appeals with the Connector. DOR has also issued a draft schedule of monthly tax penalties for 2008, based on one-half the cost of the least expensive health plans available through the Connector this year.

## LOCAL AID

Aid to cities and towns, or local aid, represents an important component of the Commonwealth's annual budget. The Administration's approach to the local aid budget reflects the Governor's and Lieutenant Governor's commitment to a strong partnership between the state and its cities and towns. Allocating a large share of the increase in spending in the fiscal year 2009 budget to local aid despite the current fiscal challenges is one of the clear ways in which the Administration is partnering with communities, and fulfills its promise not to balance the budget on the backs of the municipalities.

There are many commitments to cities and towns included in this budget, and there are initiatives proposed by this Administration to strengthen this commitment that are not included in this budget. This budget supports a total of \$6.369 billion in local school and general spending, an increase of \$310M (5.12%) over the fiscal year 2008 General Appropriations Act. The increases in local aid accounts are due to the following:

PROGRAM	FY2008 GAA	FY2009 H.2	FY2009 H.2 Increase over FY2008 GAA	% Increase
Chapter 70	\$ 3,725,671,328	\$ 3,948,824,061	\$ 223,152,733	6.0%
Veterans Benefits	\$ 15,165,374	\$ 20,904,223	\$ 5,738,849	37.8%
State Owned Land	\$ 28,300,000	\$ 30,300,000	\$ 2,000,000	7.1%
School Building Authority	\$ 634,700,000	\$ 702,000,000	\$ 67,300,000	10.6%
Charter School Reimbursements	\$ 73,790,525	\$ 81,774,660	\$ 7,984,135	10.8%
Other Cherry Sheet Items	\$ 1,581,446,607	\$ 1,585,591,123	\$ 4,144,516	0.3%
Total of Appropriated Items	\$ 6,059,073,834	\$ 6,369,394,067	\$ 310,320,233	5.1%

**Full funding for Chapter 70: \$223.1M Increase** - This is an increase of 6% over the fiscal year 2008 GAA and the second largest increase in the budget after Medicaid. Chapter 70 state aid will be at an unprecedented level totaling \$3.948B in fiscal year 2009. With this increase in aid, all 328 districts will get more Chapter 70 funds than they received in fiscal year 2008, and it ensures that the growth in each district's foundation budget is supported by the state. This year, the Governor's budget does not reflect any changes to the Chapter 70 formula, which was reformed in fiscal year 2007 by the Legislature. The Governor's budget implements the 3<sup>rd</sup> year of this 5 year phase-in model, which was set up to resolve some of the inequities of the original Chapter 70 formula that was conceived during education reform in 1993. 303 operating districts will see an increase in their foundation budgets in fiscal year 2009. Since this proposal delivers new Chapter 70 funding for all 328 operating districts, 228 of them can spend above their foundation budget.

**Veterans Benefits: \$5.7M Increase** - These funds, totaling \$20.9M in FY2009 serve as benefits to Veterans as required under MGL Chapter 115 section 6. This benefit is needs based and due to a caseload increase of 574 veterans this year (4,687 veterans in total) and anticipated increased of 755 veterans (5,442 veterans in total) in FY2009, this budget appropriately reflects our obligations to cities and towns for veterans who are entitled to benefit payments.

**Easing the Local Burden for State Property: \$2M Increase** – Many cities and towns that house state property such as facilities or office buildings fail to benefit from property tax revenue. To ease this burden, the payment in lieu of taxes (PILOT) program was established at the Treasurer's office to partially reimburse cities and towns for this revenue loss. The Governor's budget continues to make progress in providing funding for state-owned land and increases the PILOT program by \$2M, or 7%, to ease the local pressure of foregone property taxes. This account distributes funds to 292 communities and is an important program for small towns within the Commonwealth.

**School Building Assistance: \$67.3M Increase** – This \$67.3M increase brings the total to \$702M in FY2009 and reflects the state's commitment to cities and towns in providing an ongoing revenue source that allows for communities to better invest in school construction needs. The state continues to keep its promise to ensure that the use of 1% of

sales tax revenue is dedicated to building new schools throughout the commonwealth that will serve as essential resources for education our children.

**Lottery Proceeds “Shortfall” in Aid: \$124M** - Actual Lottery proceeds to be distributed to cities and towns are estimated at \$811M in fiscal year 2009, \$124M short of the \$935M recorded on the fiscal year 2008 Cherry Sheets. The Governor’s budget proposes to use one-time funds from Year 1 of destination resort casino license fees to hold communities harmless at \$935 million. This is discussed in more detail under the Budget Solutions section.

**Other Local Uses of Gaming License Fees** - Not included in the budget, but very much related to the municipal partnership, the Governor’s casino proposal would not only cover the fiscal year 2009 shortfall in the lottery, but will also provide \$88 million in direct property tax relief and \$88 million to be delivered to communities through the Chapter 90 formula to be spent on local transportation and other capital infrastructure needs.

**Regional Efficiency Assistant Grants Trust Fund** - \$3 million of budget surpluses from the Bay State Competitiveness Trust Fund will fund grants to encourage and help municipalities and regionalized authorities to implement regional approaches to delivering services. This effort is designed to improve service delivery while containing or reducing costs.

This budget proposal takes very seriously the Governor’s commitment to local aid, while recognizing that many communities need flexibility as well as direct assistance. This budget is only one part of the Governor’s continuing efforts to build a stronger partnership with municipalities. There are further municipal partnership initiatives not included in this budget that will be forthcoming in subsequent months.

**Municipal Partnership Revenue Initiatives** - In February 2007, the Governor filed the Municipal Partnership Act with the Legislature containing revenue and cost containment proposals designed to provide direct help to struggling cities and towns. To date, only certain cost containment proposals have been enacted. Closing an out-of-date property tax exemption on property used for telecommunications purposes would immediately deliver an additional \$78 million in property tax revenues. A one-percent local option meals tax would deliver \$125 million to communities; a two percent meals tax would deliver up to \$250 million to communities. Allowing communities to add one-percent to their existing hotel/motel local option tax would yield an additional \$20 million. These are revenues that other communities throughout the country have available to them in order to diversify their tax bases and relieve the pressure on property taxes.

## OTHER FINANCIAL ASSUMPTIONS USED IN HOUSE 2

### Debt Service

Debt service is a significant expense in the Commonwealth's budget. Facing the constraints of a tight operating budget, the Administration has adopted a thoughtful and fiscally responsible approach to managing its debt over the long-term to *keep debt service at an affordable level* while allowing the Commonwealth to increase its investment in the general capital infrastructure needs of the state. This debt policy and the debt affordability analysis upon which it is based can be viewed in their entirety on [Mass.gov/EOAF](http://Mass.gov/EOAF).

### Debt Service Generally

Although a portion of the Commonwealth's capital investments is funded from federal grants and other sources, the Commonwealth borrows funds through the issuance of bonds to fund the majority of its capital investments. The issuance of bonds generates financial resources to fund capital programs, and also results in obligating future annual operating revenue for repayment of the bonds. Debt service is the annual payment of principal and interest on these borrowed funds.

The following table shows the debt service payment obligations on outstanding bonds of the Commonwealth as of October 1, 2007:

**Debt Service Requirements on Commonwealth Bonds as of October 1, 2007**  
(in millions)

Fiscal Year	Debt Service	Fiscal Year	Debt Service	Fiscal Year	Debt Service
2009	2,152	2019	1,080	2029	348
2010	2,057	2020	1,105	2030	342
2011	2,067	2021	1,260	2031	340
2012	1,902	2022	1,012	2032	140
2013	1,901	2023	888	2033	138
2014	1,818	2024	773	2034	160
2015	1,810	2025	680	2035	107
2016	1,520	2026	516	2036	106
2017	1,570	2027	492	2037	107
2018	1,104	2028	289	2038	77
				<b>TOTAL:</b>	27,861

The issuance of bonds to fund capital projects must be approved by a two-thirds vote of each house of the Legislature. The State Treasurer is responsible for the issuance of the Commonwealth's debt obligations upon the request of the Governor. The Governor, through A&F, allocates the proceeds of the bonds to support authorized projects.

The Commonwealth's debt takes a number of forms. This includes direct debt, such as general obligation debt (secured by a pledge of the full faith and credit of the Commonwealth, special obligation debt (secured by a pledge of certain receipts credited either to the Highway Fund (Transportation Fund) or Convention Center Fund) and federal grant anticipation notes (secured by a pledge of federal highway construction grants). In addition to direct debt, the Commonwealth has a number of other debt-like long-term liabilities, including contract assistance payments, lease-financing payments and contingent liabilities. Contract assistance payments and lease financing payments are required to be made by the Commonwealth to certain other public or quasi-public entities to support all or a portion of the debt service on certain bonds issued by these entities to fund public infrastructure improvements. Contingent liabilities relate to debt issued by independent authorities or other agencies of the Commonwealth that is expected to be paid by the issuing entities, but the payment of debt service or replenishment of reserves is guaranteed by the Commonwealth if expected payment sources are inadequate.

### **Debt Affordability**

In its first year, the Patrick-Murray Administration published a thorough debt affordability analysis and policy for determining the state's annual borrowing limit, or "bond cap". This is the first time an Administration has engaged in such an analysis and published a transparent, rational policy for determining the annual bond cap. The Administration believes that this analysis and policy is necessary to ensure that the state's capital budget is based on a level of debt that will keep annual debt service payments in the operating budget to affordable levels.

Based on the debt affordability analysis, the Administration established a policy for setting the bond cap subject to the following constraints: (a) payment of debt service and debt-like obligations for existing and new debt must stay within 8% of total annual budgeted revenues and (b) future growth of the bond cap is limited to not more than \$125 million per year.

Based on the debt affordability analysis and the policy for setting the annual bond cap described above, the Administration has projected that the Commonwealth will have the capacity to accommodate steady increases in the bond cap over the next few years while *decreasing* the percentage of the Commonwealth's annual budgeted revenues needed to pay debt service during that period. This will result in increased capacity in the capital budget to make needed investments in public infrastructure and greater capacity in the operating budget to fund needed state programs.

**Projected Debt Service as a Percentage of Budgeted Revenues<sup>1</sup>**  
**Fiscal Years 2008-2012 (in millions)**

Fiscal Year	Bond Cap	Existing Debt Service Obligations	Cumulative New Debt Service from Annual Bond Cap	Total Debt Obligations	Estimated Budgeted Revenue	Debt Service as % of Budgeted Revenues
2008	\$1,500	\$2,064	\$33	\$2,097	\$26,727	7.85%
2009	1,625	2,039	142	2,181	27,529	7.92%
2010	1,750	1,926	261	2,187	28,355	7.71%
2011	1,875	1,884	388	2,273	29,205	7.78%
2012	2,000	1,703	524	2,228	30,081	7.41%

Before July 1, 2008, the Administration will publish a new debt affordability analysis and annual bond cap determination for fiscal year 2009 based on the policy set forth above and based on updated budgeted revenue and debt service payment assumptions. The Administration intends to revisit the debt affordability analysis each year to reflect fluctuations in interest rates, revenues, and other changes impacting the Commonwealth's debt capacity.

The Governor's fiscal year 2009 budget proposal includes debt service appropriations to cover the payment obligations on outstanding bonds and to cover expectations regarding upcoming bond issues developed in accordance with the debt affordability analysis and policy described above

### **Transfer of State Personnel from the Capital Budget to Operating Budget**

Section 28 of the Governor's fiscal year 2009 budget authorizes a no-cost mechanism for taking hundreds of personnel and other budgetary expenses off of the capital budget with the goal of significantly scaling back the

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<sup>1</sup> This table is extracted from the Debt Affordability Analysis published in July 2007 and reflects estimated budgeted revenue and debt service assumptions made at that time. The debt service payment obligations reflected in the table also include not only debt service on Commonwealth bonds, but also contract assistance and lease financing payment obligations of the Commonwealth on bonds issued by other public and quasi-public entities.

fiscally imprudent practice of funding these expenses with debt. For every dollar we spend on the capital budget, an additional \$0.60 is added in interest costs. For a number of years, commodities such as personnel and other non-durable goods have been charged to the capital account - resulting in millions of additional dollars in interest payments while reducing the amount of money available for statewide construction projects. The Administration recently filed a bond bill seeking authorization to borrow \$50 million a year to fund the acquisition of equipment on the capital budget instead of the operating budget. If this bond authorization is passed, \$50 million in the operating budget will no longer be needed to fund equipment acquisitions, creating capacity in the operating budget to fund \$50 million of personnel and operating-related expenses currently being paid for with borrowed funds.

Section 28 would give A&F the authority to transfer money between line items in the operating budget to ensure the initiative is cost neutral. If a line-item funded the acquisition of durable equipment, this outside section would allow A&F to transfer that amount to another line-item to fund the cost of personnel that would have otherwise been funded from the capital budget.

The total amount of such transfers cannot exceed \$50 million, and A&F will be required to give the Senate and House Committee on Ways and Means a schedule of all such transfers. This outside section and the bond authorization must both be passed in order to implement the proposed transfer of personnel from the capital budget to the operating budget.

## **Earmark Policy for H.2**

The Governor's fiscal year 2009 budget includes funding in a number of agency line items for specific programs and organizations that were earmarked and funded in fiscal year 2008. These purposes are consistent with the programs and services provided by the agencies where the funds are being appropriated. While the funding is not specifically earmarked in the document, this Administration expects that the budgeted amounts will be directed, via the appropriate state agency, to the programs and organizations.

Elsewhere, the Governor's fiscal year 2009 budget eliminates nearly 300 other earmarks totaling approximately \$40 million that were included in the fiscal year 2008 budget. These earmarks were inconsistent with the mission of the agency under which they were funded or otherwise not affordable in a challenging budget year. An additional \$70 million of earmarks are part of the MassHealth savings and so they are not represented in this total. While these earmarks have been removed, valued programs and organizations may still be able to receive state funds in fiscal year 2009. The Governor's fiscal year 2009 budget recommends \$15 million for the Workforce Competitiveness Trust Fund, \$7 million for the Massachusetts Cultural Facilities Fund and \$5 million for a new Regional Tourism Grant Program. These programs would allocate funding through a competitive grant process and in some cases leverage private matching dollars. In this way, the Administration has taken steps in this budget toward a more transparent, equitable and responsible process of allocating funds to the myriad of programs and organizations throughout the Commonwealth.

### *Workforce Competitiveness Trust Fund (WCTF) - \$15 million <sup>2</sup>*

The WCTF was established in the economic stimulus legislation of 2006 to provide resources for industry-specific employment and training programs developed in collaboration between regional and community-based organizations, industry, labor organizations, and state and local government agencies. The WCTF<sup>3</sup>, which is administered by the Commonwealth Corporation, has proven to be remarkably successful, awarding competitive 3-year grants for projects to train or re-train workers across the state, building on the strengths of the Massachusetts workforce. Grant funding represents a key resource for workforce development organizations

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<sup>2</sup> Funding for the Workforce Competitiveness Trust Fund and Massachusetts Cultural Facilities Fund would be via the Bay State Competitiveness Investment Trust Fund which would be capitalized through a consolidated net surplus in the Commonwealth's budgeted funds in fiscal year 2008.

<sup>3</sup> This program should not be confused with the existing Workforce Training Fund, which is financed by employers to provide resources to Massachusetts businesses and workers to train current and newly hired employees.

across the Commonwealth to leverage their employment programs and initiatives with state dollars, while ensuring balanced economic development and growth.

*Regional Tourism Grant Program - \$5 million*

This new initiative would provide \$5 million in fiscal year 2009 in competitive grants for tourism advertising and promotion, regional branding, and other local projects to attract in-state, out-of-state, and overseas travelers to the state's numerous cultural, historical, and natural attractions. The grant program is designed to match investments made by local or regional organizations with state funding. These grants would be available to local groups across the state and would complement the efforts of the state's tourism promotion partner agencies and the Massachusetts Office of Travel and Tourism (MOTT), which would be responsible for administering the program.

*Massachusetts Cultural Facilities Fund (CFF) - \$7 million*

CFF grants, which are awarded by the board of the Mass Development Finance Agency, are selected on a competitive basis to provide essential funding to non-profit cultural organizations, municipalities, and institutions of higher education to support their efforts to preserve and maintain cultural facilities. This program, initially created in 2006 by the Massachusetts Legislature, is a vital tool in providing investments in cultural and historical attractions across the state. Grant awards are based on a variety of factors including community and financial need, benefit to the local and regional tourism market, and local support for the project. All grants from the Fund must be matched with cash contributions from the private or public sector.

## FTE Assumptions

Chapter 29, Section 6 states "The operating budget shall indicate the number of positions proposed to be authorized for each state agency or such other public instrumentality for the ensuing fiscal year, the number of positions for each state agency in the current and ensuing fiscal years and such other information as may be held to explain the anticipated results of the proposed expenditures". Thus, H.2 should include the historical and projected number of Full Time Equivalents (FTEs) for each agency.

The FY09 H.2 budget recommendations include funding for 68,509 FTEs across state government. This represents an increase of 0.48% (330) over the January 5, 2008 employment levels.

Government Area	June FY2005	June FY2006	June FY2007	Jan. FY2008	Projected FY2009
Judiciary	7,435	7,630	7,993	7,918	8,183
Independents	6,561	6,771	7,101	7,236	7,363
Administration & Finance	2,848	2,929	2,791	2,858	2,968
Energy & Environmental Affairs	2,108	2,201	2,168	2,199	2,371
Health & Human Services	21,116	21,055	21,117	21,338	21,635
Transportation	1,139	1,078	1,087	1,227	1,399
Housing & Economic Development	580	585	610	627	687
Labor & Workforce Development	324	323	320	334	343
Education	13,439	13,362	13,777	14,954	13,911
Public Safety	8,109	8,430	8,457	8,442	8,587
Legislature	1,053	1,076	1,062	1,046	1,062
<b>TOTAL</b>	<b>64,713</b>	<b>65,439</b>	<b>66,483</b>	<b>68,179</b>	<b>68,509</b>
FY08-FY09 Variance		726	1,044	1,696	330
FY08-FY09 % Growth		1.11%	1.57%	2.49%	0.48%

**Note:** If County Sheriffs legislation is enacted, an additional 2,800 FTEs will be added in fiscal year 2009. This will increase the growth rate between fiscal year 2008 – fiscal year 2009 to 4.4%.

The additional hires can be attributed to critical investments made in the FY08 GAA and specific items included in the H.2 recommendations. Staffing level increases have been funded for the following reasons:

- **Policy Change / Initiative** – FY09 H.2 recommends some additional employees that coincide with changes and consolidations of line items. One example of an initiative that is included in H.2 is legislation to bring County Sheriffs departments on as state employees. This would increase the total FTE level in H.2 by approximately 2,800 employees for the 7 County Sheriff Departments. Other initiatives include requiring 40 additional employees at the Judiciary consistent with staffing levels recommended by the Monan Report; and 25 new employees at the Division of Banks for the mortgage loan originator legislation enacted in FY09, among others.
- **Targeted Investments** – The Governor includes specific investments in the budget that will require additional staff to implement. Examples of these investments would include 146 across the Environmental Agencies consistent with the Beaches Commission recommendations and to implement regulations passed in FY08 for a Regional Greenhouse Gas initiative; 130 at the Department of Revenue to implement enhanced tax enforcement; 70 for additional Social Workers at the Department of Social Services to address staff to case ratio levels; and 45 across our Education agencies to assist in the investments made to continue to develop our world class education system.
- **Contractor / Capital Conversions** – Given the cost associated with paying for employees from capital funds and the renewed focus on wage enforcement efforts, every effort was made to convert contract employees to full-time equivalents, and to transfer employees onto the operating budget. Additionally, H.2 includes an outside section that will increase this amount as costs will be converted between the capital and operating budgets to move more employees off of the high cost capital payroll. (Capital FTEs are not new state employees, they are just new to the operating budget.)
- **Critical Hires for Public Health and Safety** – Certain direct care and safety staffing positions in specific departments often work with our state's most vulnerable populations, it is critical that staffing levels are maintained so that the most qualified, trained, and experienced staff are helping our state's residents in areas of Public Health, Mental Health and Mental Retardation.
- **Backfills** – Every organization has natural turnover of staff as personnel leave and are replaced. At any given time, a payroll snapshot will be incomplete because it does not capture the open positions which are being recruited. Responsible budgeting includes those funding for those critical hires, but the reality may be that the position goes unfilled, or once that position is hired, another position is vacated.